Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term 1976

No. 76-248

REUBEN P. HUGHES,

Petitioner,

vs.

DEMPSEY-TEGELER & CO., INC., a Delaware corporation, LEWIS WHITNEY and NEW YORK STOCK EXCHANGE, INC., a New York corporation,

Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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DEMPSEY-TEGELER & CO., INC., a Delaware corporation, LEWIS WHITNEY and NEW YORK STOCK EXCHANGE, INC., a New York corporation,

Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

The petitioner Reuben P. Hughes (''Hughes'') prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on March 29, 1976.

Opinions Below.

The opinion of the Court of Appeals is reported in 534 F.2d 156 (9th Cir. 1976). The opinion of the District Court for the Central District of California is reported in (1973 Transfer Binder) CCH Fed. Sec. L. Rep., §94,133 (C.D. Cal. 1973). Both opinions are reproduced in the Appendix. -A 94

Jurisdiction.

The judgment of the Court of Appeals was entered on March 29, 1976. A timely petition for rehearing and rehear-

ing en banc was denied on June 4, 1976. This petition was filed within 90 days of that date. This court's jurisdiction is invoked under 28 U.S.C. §1254(1).

Questions Presented.

In determining whether a common law defense should bar recovery for a violation of the Securities Exchange Act of 1934 (''34 Act''):

Should there be any circumstances which would allow a defense when a national securities exchange has knowingly breached its enforcement duties under 15 U.S.C. §78f (''Section 6'').

Should the standards for allowing a defense be any different under Section 6, an enforcement provision, than they are under 15 U.S.C. §78j(b) (''Section 10b''), an anti-fraud provision?

Where a plaintiff's conduct is the basis for a defense, should the standard adopted by the fifth circuit to govern a 10b action become the standard for allowing a defense under Section 6.[1]

Should 15 U.S.C. §78cc (''Section 29'') which declares void a waiver of compliance with any provision of the 34 Act, be limited to written waivers?

Statutes Involved.

This case presents a question of first impression in this court concerning whether common law defenses should be

[1]The standards applied by the Fifth Circuit to a 10b claim require that the fault of the plaintiff be equal and simultaneous with the fault of the defendant and vital to the defendant's breach, and that the purpose of the securities laws be furthered more by allowing the defense than by disallowing it. *Woolf v. S. D. Cohn & Co.*, 515 F.2d 591 (5th Cir. 1975); petition for rehearing denied 521 F.2d 225 (1975).

allowed to bar a plaintiff's recovery in an action brought under Section 6 of the 34 Act, an enforcement provision. Section 29 of the same Act is pertinent to the applicability of the doctrine. Sections 6 and 29 of the 34 Act are reproduced in the Appendix hereto. The provisions of 15 U.S.C. §78h(b) and the New York Stock Exchange Inc. (''Exchange'') Constitution and Rules, all pertinent to the Section 6 duty of the Exchange to regulate its member firm, Dempsey-Tegeler & Co., Inc. (''Dempsey''), are also reproduced in the Appendix hereto.

Statement of the Case.

Hughes, a citizen of California, brought suit in the United States District Court, Central District of California. Federal jurisdiction over his claims against the Exchange, a New York Corporation and Dempsey, a Delaware Corporation, was provided under 15 U.S.C. §78aa. Trial determined that Hughes' loss was $1,614,993.18.

In the regular course of carrying out is statutory obligation to police the operations of Dempsey, the Exchange, in September 1969, received Dempsey's financial audit and questionnaire. Both the audit and the questionnaire revealed that Dempsey was perilously close to insolvency and deteriorating in every important aspect of its operational and financial condition, a situation which evidenced a worsening of 1968 problems. Dempsey's 1969 condition had become so grave, and its continued operation so gross a violation of Exchange Rules, that questions were immediately raised by staff members of the Securities Exchange Commission (''SEC'') and by the Exchange Constitution itself concerning whether the

Exchange had a mandatory duty to close Dempsey's doors.[2] The Exchange answered these questions in a contradictory manner. To lessen the danger to Dempsey's customers, the Exchange restricted Dempsey's operations. At the same time, the Exchange encouraged Dempsey to raise capital through borrowings from those same customers in subordination transactions.

The District Court found that the options open to the Exchange in regulating Dempsey had been "narrowed by the burgeoning inertia of its past decisions." Since 1949, the Exchange had been compelled on several occasions to take action against Dempsey because of its serious operations problems. More recently, because of a grossly deficient 1968 audit, the Exchange was required to restrict Dempsey's operations. These restrictions ended in a few months with an Exchange prescribed placebo of subordinated capital. Through an interpretation of its Constitution and Rules favorable to Dempsey, the Exchange gave capital credit for the subordination of unregistered, unmarketable Siboney stock.[3]

Because of the deluding ease by which subordinated capital had glossed over Dempsey's 1968 problems, the Ex-

[2]During meetings held in the fall of 1969 between staff members of the SEC and officials of the Exchange, the staff took the position that Dempsey's continued operation would be a fraud upon the public and that the proper regulatory response would be a closing of Dempsey's doors. As recently as December of 1968, the Exchange, in order to eliminate the delay attending protracted hearing procedures, had amended its constitution to require the summary suspension of any member which ". . . is insolvent, or is in such financial or operating condition that it cannot be permitted to continue in business with safety to its creditors. . . ." Article XIII, Exchange Constitution, Section 1.

[3]The Exchange, through a relaxed interpretation of its enforcement responsibilities, gave Dempsey more than 9 million dollars of capital credit for unregistered common stock of Siboney Corporation, although such stock was not entitled to any capital credit under Exchange Rule 325.

change not only prescribed but personally administered another sugar-coated pill for Dempsey's 1969 moribund state. Exchange officials actively sought a subordinated loan from John King ("King") and then granted Dempsey 7 million dollars of capital credit for a subordination of unregistered, and therefore unmarketable, common stock in King Resources Company. The Exchange at that time was hoping for a turn-around in a market which was then in the throes of the longest sustained decline since the Depression. Concurrently, and reacting to the Exchange prescription, Dempsey officials negotiated with Hughes for his subordination of high grade, negotiable bonds and securities. The subordination was completed on March 24, 1970. Within four months of the Hughes' loan, Dempsey's liquidation began and Hughes was completely sold out. The relation between Hughes and his long-time friends and fiduciaries Lewis Whitney ("Whitney") and James Walraven ("Walraven"), the true and the false statements made to Hughes, and the abandonment of its regulatory duties by the Exchange, all factors in Hughes' loss, were to plague the Section 6 and waiver issues before the District Court and Court of Appeals.[4]

Partly because of his wealth — which came from an early

[4]Particularly troubling to the waiver issue was the testimony of Robert Peck ("Peck") — just hired to research Dempsey's problems — that he gave documents to Hughes which emphasized very recent and great Dempsey progress in overcoming operational and net capital problems. While discussing these documents, Peck told Hughes that there was a good chance that he could lose his money. This negative sell was quickly followed by assurances, in Peck's presence, from both Walraven and Whitney that every investment was subject to risk but that the risk of loss in a Dempsey investment "was nil" since Dempsey was a "sound firm with a sound net worth." The District Court found that the sum of this information resulted in a waiver by Hughes of both a 10b and a Section 6 breach. The Ninth Circuit agreed while cautioning against too easy an application of 10b waiver factors to a Section 6 breach. It held that a waiver under Section 6 depended upon a knowing relinquishment by Hughes of the Exchange's enforcement obligations.

and modest investment in a one-product company (Hawaiian Punch), a product which caught on in phenomenal fashion — and partly because of his close, twenty-year personal relationship with his securities broker, Walraven, Hughes was a natural target for a subordination solicitation. Whitney, President of Dempsey, joined Walraven to make the case for subordination. Hughes had known Whitney for almost as long as he had known Walraven, although in a less personal way. Robert Peck ("Peck"), hired by Dempsey only a few weeks before the subordination, and a stranger to all, appeared for the closing presentation to Hughes. The District Court found that — although false statements were made to Hughes about Dempsey's financial and operating condition — because he had been given complete access to information relating to his loan, a complete disclosure had been made to Hughes. The total presentation consisted of separate and seemingly conflicting lines of advice. One line warned that Dempsey was in serious violation of Exchange net capital requirements. The other line assured that Dempsey was a sound firm with a substantial net worth. The seeming conflict was smothered in complicated distinctions between net capital and net worth which the District Court found were beyond the ability of Walraven and Whitney to grasp. Nevertheless, they each spoke to Hughes out of an authority which office and years of specialty gave. From that authority, the very need for capital was made to seem a reason for subordinating.[5]

[5]The Dempsey fiduciaries represented that Exchange determinations of net capital deficiencies were only a technical by-product of a great volume of business; record keeping had lagged; Dempsey's true worth, unrecorded, could not be counted in the net capital determinations, an unfair effect upon a sound firm. Hughes was also told, in emphasis of the technical and vagrant nature of the Exchange rules, that Dempsey's

(This footnote is continued on next page)

Included in the information given to Hughes were documents of Exchange origin. These documents contained no specific representation of Dempsey's financial soundness. However, they did give official approval to the subordination and of the false fact that Dempsey was in compliance with Exchange rules. The Exchange documents, the relaxation of its net capital requirements through rule interpretation and the encouragement of subordination by the Exchange, prompted the District Court to describe the Exchange as the "major protagonist" in the Hughes transaction.

One Exchange document given to Hughes reported its release of Dempsey from regulation. Another document, signed by Hughes, contained a stipulation that he was not relying upon the Exchange's surveillance of Dempsey; it also included Hughes' "agreement" that the Exchange had no responsibility to disclose to him information concerning Dempsey. Peck-produced documents dovetailed nicely with the Exchange documents by falsely detailing great Dempsey progress in overcoming problems. One of these documents claimed that Dempsey, within only 4 months, had reduced its net capital deficit from 19.9 million dollars to 5.8 million dollars, a deficit which would be eliminated by the King loan. The true fact, known only to the Exchange through computations of its own examiners, was that at the time of the Hughes loan Dempsey had an actual net capital deficiency of 17.9 million dollars. The Exchange also knew that at that time Dempsey's operating condition was still deteriorating. Nevertheless, the Exchange decided to lift its restrictions

potential net capital deficit could be from 6 to 16 million dollars more than a *determined* 5.6 million. Hughes was also falsely assured that the King subordination, by itself, would put Dempsey in capital compliance since the amount of the King subordination was greater than the existing and actual deficit.

against Dempsey's operations. The Ninth Circuit found that the Exchange knowingly had breached its Section 6 duties by lifting its restrictions against Dempsey's operations. However, the Court also found that Hughes had waived that breach by encouraging the Exchange to lift those restrictions.[6]

[6]The Ninth Circuit determined that Hughes conditioned his subordination upon the lifting of the restrictions. However, there was neither a District Court finding nor evidence to support the determination. Interesting questions are raised by the Ninth Circuit's determination. However, the determination itself does not prejudice the right of Hughes to recover; for if Hughes did negotiate for a lifting of the restrictions in the transaction and thereby can be said to have waived the Exchange's violation of Section 6, Section 29 should render his waiver void. Actually, it was King, not Hughes, who had conditioned his subordination upon the lifting of the restrictions. Hughes was not privy to the details of the King subordination meetings. He had never met King and knew only what Walraven and Whitney told him about those meetings. They told him that: King's accountants and lawyers had made an extensive investigation of Dempsey's condition; the King subordination was enough to put Dempsey in capital compliance; and that King was awaiting Exchange and SEC decisions regarding the regulatory remedy for Dempsey. From the information given him, Hughes understood that the lifting of the restrictions made the subordination "the proper thing to do."

REASONS FOR GRANTING THE WRIT.

1. A Plaintiff's Encouragement to a Regulator to Breach a Congressionally Imposed Duty to Regulate Should Not Act as an Excuse for a Knowing Breach.

The Ninth Circuit decision, by permitting a common law defense to bar recovery for a knowing breach of a Section 6 enforcement duty, raises unsettling questions about the accountability of national securities exchanges in fulfilling their statutory obligations — questions which trouble a system of private regulation founded upon the exchanges' promises to be accountable. The powerful economic forces set in motion by the securities industry, require, for beneficial, national direction, the self-restraint of integrity, born of accountability. The courts have spoon-fed accountability by allowing private rights of action for a regulator's breach. In time, issues arose in these actions as to whether, and by what standards, the courts should allow common law defenses to bar recovery. The Ninth Circuit decision, by allowing a defense to Section 6, on the basis of the plaintiff's encouragement of the defendant's breach of the section, conflicts with other circuit decisions which have refused to allow defenses in suits brought for a knowing breach of a duty under an enforcement provision.[7]

The particular emphasis and basis of the Ninth Circuit's waiver decision[8] is the "loss of innocence" of Hughes

[7]The question of whether to allow common law defenses to bar recovery for a violation of a security law has been the subject of many district court decisions which are here ignored because of the many decisions of the circuit courts on the subject.

[8]The particular defense involved in the Ninth Circuit decision is labelled "waiver." However, the court discusses the defense in terms of the fault existing in Hughes, an *in pari delicto* concept. Whatever ambiguity may exist in the labelling is considered by Hughes as having no affect upon the principles under discussion.

which, in the Section 6 claim, rests upon a finding that Hughes encouraged the Exchange to breach its enforcement duties. But no amount of encouragement from a plaintiff should relieve a defendant of a congressionally imposed enforcement duty. The Second Circuit in *Pearlstein v. Scudder & German,* 429 F.2d 1136 (2d Cir. 1970)[9] permitted recovery to a less than innocent investor — even an unscrupulous one who would reap a windfall by recovery — when the one charged with the duty to enforce a statute knowingly breached that duty. The *Pearlstein* court was aware of the distastefulness of permitting an unworthy investor to recover. *Pearlstein* was decided as it was — and has merit as a principle — because the distastefulness of permitting a recovery to an unscrupulous investor is outweighed by the need to compel those with an enforcement duty to fulfill that duty.

Hughes does not seek after the *Pearlstein* doctrine as does a scoundrel who seeks sanctuary among other scoundrels. There was nothing unscrupulous in the conduct of Hughes in this transaction. He was found wanting out of a lack of diligence — out of trusting too much to pursue information to which he was given access — not out of any desire to gain

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[9]The Second Circuit in *Pearlstein v. Scudder & German,* 429 F.2d 1136, 1143 (2d Cir. 1970), *cert. den.*, 401 U.S. 1013, 91. S.Ct. 1250, 29 L.Ed. 2d 550 (1971), after remand, 527 F.2d 1141 (1975), refused to permit a defense to bar recovery on the grounds that denying the common law defenses in private suits act as a prod to those with enforcement obligations to properly perform their obligations. The Sixth and Eighth Circuits have followed *Pearlstein. Naftalin & Co., in re,* 469 F.2d 1166 (8th Cir. 1972); *Spoon v. Walston,* 478 F.2d 246 (6th Cir. 1973). After the *Pearlstein* decision, Congress added 7(f) to the 34 Act which placed a responsibility upon the investor, along with the broker, to comply with margin requirements. Thus, the rationale of *Pearlstein* — as it specifically relates to Section 7 of the 34 Act — may no longer be valid. *Pearlstein v. Scudder & German,* 527 F.2d 1141, note 3 (2d Cir. 1975). Nevertheless, the principle itself remains sound.

advantage.[10] Upholding the doctrine is not at all essential to Hughes' right to recover. The doctrine is only one way to resolve the conflict between promoting the objectives of required private regulation under the securities laws through a disallowance of defenses and the objectives of allowing common law defenses.

2. Even the Standards Which Have Been Adopted to Govern Anti-Fraud Actions Would Not Permit a Defense to Bar Recovery for a Section 6 Breach Where the Fault of the Plaintiff Rests Upon His Negotiation for a Lifting of Regulation.

Defenses have been allowed to defeat a suit brought under an anti-fraud provision — in special circumstances.[11] Defenses have also been disallowed.[12] In denying a petition for rehearing in *Woolf v. S. D. Cohn & Co.*, 521 F.2d 225 (5th Cir. 1975), the Fifth Circuit explained its reasons for disallowing an *in pari delicto* defense. The circuit reviewed the growth of the defense, which had emerged prior to the adoption of federal regulatory schemes governing commerce and finance, and noted that even the early allowance of the

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[10]Even the normal desire for an unusual profit should not be ascribed to Hughes. He was a man who, at that time, would have paid a 70% tax on the ordinary income which the investment was designed to yield. If petitioner was guilty of anything, it was of friendship.

[11]The Fifth Circuit in *James v. Dubriel,* 500 F.2d 155 (5th Cir. 1974) and *Kuenhart v. Texster,* 412 F.2d 700 (5th Cir. 1969) permitted a common law defense to defeat recovery. In both cases the plaintiff had conspired with the defendant to circumvent the securities laws. In both cases, the Court declined to settle accounts between co-conspirators where the transaction had no affect upon the investing public. The Fourth Circuit, in *Malamphy v. Real-Tex Enterprises, Inc.*, 527 F.2d 978 (4th Cir. 1975), allowed an *in pari delicto* defense where the plaintiffs had culpably participated with defendant in a violation of the securities laws.

[12]*Woolf v. S. D. Cohn & Co.*, 515 F.2d 591 (5th Cir. 1975), petition for rehearing denied, 521 F.2d 225 (1975).
Can-Am Petroleum Co. v. Beck, 331 F.2d 371 (10th Cir. 1974).
Katz v. Amos Trust & Co., 411 F.2d 1096 (2d Cir. 1969).

defense required that the wrongdoing of a plaintiff bear an immediate and necessary relationship to the relief sought from the court. Then, addressing the plaintiffs' 10b claim, the court reaffirmed its earlier decision not to allow the defense, even though the plaintiffs were not free from sin, stating:

> "But the question is not the purity of the plaintiffs in an abstract sense, but rather whether their fault was equal, simultaneous, and vital to the effectuation of the fraudulent scheme (as the cooperation of a co-conspirator is vital to the accomplishment of the ends of a conspiracy); and whether the remedial purposes of the securities laws will be furthered more by allowing the defense than by disallowing it. . . . ." *Woolf, supra,* p. 228.

As an aid to its decision, the *Woolf* court noted a similarity between the development of the law in the anti-trust area a good many years before regulation of the securities industry. A conflict emerged among the circuits, with some circuits refusing recovery to a plaintiff *in pari delicto* and other circuits deciding to promote the regulatory objectives of anti-trust legislation by refusing to allow the defense. The Supreme Court stepped in to settle the matter.[13] There is now a need for the Supreme Court to do the same in the securities area — to coalesce the varying opinions of the various circuits into one clarifying standard. The Fifth Circuit on page 227 of *Woolf* took note of this need.

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[13]*Perma Life Mufflers, Inc. v. International Parts Corp.* (1968), 392 U.S. 134, 88 S.Ct. 1981, 20 L.Ed. 2d 982; *Simpson v. Union Oil Co.* (1964), 377 U.S. 13, 84 S.Ct. 1051, 12 L.Ed. 2d 98; *Kieter-Stewart Co. v. Seagram & Sons* (1951), 340 U.S. 211, 71 S.Ct. 259, 95 L.Ed. 219.

3. A Decision of the Supreme Court Would Act as Guidance to Resolve Suits Pending in the District Courts.

A decision of the Supreme Court could not be more timely. Of the many suits which were filed after the 1969-70 practices of exchanges were revealed,[14] this is the first to be decided by a circuit court. The district courts, now asked to decide these often complex suits, the SEC, the securities industry and the investing public would benefit from a clear statement of the principles to be applied to the assertion of common law defenses.

4. Section 29 Renders Void Negotiated Oral Understandings Which Amount to a Waiver of a Section 6 Duty.

In its decision the Supreme Court should consider the effect of Section 29 of the 34 Act. The Ninth Circuit noted that any waiver contained in a letter signed by Hughes was void under Section 29. In that letter, Hughes acknowledged that he had been ". . . furnished with all financial information with respect to Dempsey . . ." and that he was not relying "upon the Exchange's surveillance of the organization or its capital position." Despite the bar of Section 29, the

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[14]There have been a number of official studies which were submitted to Congress covering the attempt of the Exchange to assist its weakest members by ignoring their rule violations in the hope that time would dispense with the need for regulation. The Exchange practice, which led to millions of dollars of investor damage, was reported in a Senate Study of Self-Regulation in the Securities Industry, Ninety-Second Congress, Second Session. During hearings held on August 8 and 9 and on October 5, 1972, the number of suits then in process was reported to be thirty (pp. 241, 242 of the Senate Study, judicially noticed by the trial court as judicially noticed materials Exhibit B). At the present time there are at least 12 suits against various exchanges still pending before the trial courts. Because he does not have the means of ferretting out all of the suits filed in the various district courts, Hughes does not know how many other suits have been filed against exchanges involving the same issues as his suit.

Ninth Circuit found a waiver, not because of the letter, but because Hughes knew of the restrictions and because he had negotiated for their lifting, thereby encouraging the Exchange to breach its duty. Such a finding makes a distinction between a waiver contained in a writing (invalid) and a waiver which is brought about during oral negotiation (valid). The First Circuit in *Rogen v. Ilikon,* 361 F.2d 260, 268 (1st Cir. 1968) warned against too narrow an interpretation of the language and circumstances of waiver. Section 29 does not purport to void only written waivers, its language embraces a plaintiff's negotiated oral condition, which condition amounts to a waiver.

Conclusion.

For the above reasons, a writ of certiorari should issue to review the judgment and opinion of the Ninth Circuit.

Respectfully submitted,

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APPENDIX

APPENDIX.

PERTINENT PROVISIONS OF THE 1934 ACT.

Section 6 of the Securities Exchange Act of 1934, 15 U.S.C. § 78f.

REGISTRATION OF NATIONAL SECURITIES EXCHANGES

Sec. 6. (a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this title, and any amendment thereto and any rule or regulation made or to be made thereunder;

(2) Such data as to its organization, rules of procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the ''rules of the exchange''; and

(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

(c) Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which it is located.

(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

(e) Within thirty days after the filing of the application, the Commission shall enter an order either granting or, after appropriate notice and opportunity for hearing, denying registration as a national securities exchange, unless the exchange applying for registration shall withdraw its application or consent to the Commission's deferring action on its application for a stated longer period after the date of filing. The filing with the Commission of an application for registration by an exchange shall be deemed to have taken place upon

the receipt thereof. Amendments to an application may be made upon such terms as the Commission may prescribe.

(f) An exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration.

Section 8 of the Securities Exchange Act of 1934, 15 U.S.C. § 78h.

RESTRICTION ON BORROWING BY MEMBERS, BROKERS, AND DEALERS

Sec. 8. It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly —

(a) . . .

(b) To permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons, including customers' credit balances (but excluding indebtedness secured by exempted securities), to exceed such percentage of the net capital (exclusive of fixed assets and value of exchange membership) employed in the business, but not exceeding in any case 2,000 per centum, as the Commission may be rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.

(c) In contravention of such rules and regulations as the Commission shall prescribe for the protection of investors to hypothecate or arrange for the hypothecation of any securities carried for the account of any customer under circumstances (1) that will permit the commingling of his securities without his written consent with the securities of any

other customer, (2) that will permit such securities to be commingled with the securities of any person other than a bona fide customer, or (3) that will permit such securities to be hypothecated, or subjected to any lien or claim of the pledgee, for a sum in excess of the aggregate indebtedness of such customers in respect of such securities.

(d) . . .

Section 29 of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc.

VALIDITY OF CONTRACTS

Sec. 29. (a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

(b) Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation . . .

PERTINENT PROVISIONS OF THE CONSTITUTION OF THE EXCHANGE.

Article XIII, Exchange Constitution, Sections 1 and 2.

ARTICLE XIII

INSOLVENT MEMBERS—SUSPENSION—REINSTATEMENT

Sec. 1. A member who fails to perform his contract, or is insolvent, shall immediately inform the Secretary of the Exchange in writing that he is unable to meet his engagements and prompt notice thereof shall be given to the Exchange. Such member shall thereby become suspended from membership until he has been reinstated as provided in Section 5 of this Article.

Suspension for insolvency on declaration

A member or allied member who is a general partner in a member firm or a holder of voting stock in a member corporation, which firm or corporation fails to perform its contracts, or is insolvent, or is in such financial or operating condition that it cannot be permitted to continue in business with safety to its creditors or the Exchange, shall immediately inform the Secretary of the Exchange in writing of such fact and prompt notice thereof shall be given to the Exchange. Such member firm or member corporation shall thereby become suspended as a member firm or as a member corporation and every member or allied member who is a general partner or holder of voting stock therein shall thereby become suspended from membership or allied membership, until reinstated as provided in Section 5 of this Article.

Notice from Exchange — Suspension

Sec. 2. Whenever it shall appear to the Chairman of the Board that a member has failed to meet his engagements, or is

insolvent, or the Chairman of the Board has been advised by the Board of Directors of the Exchange or by the Board of Directors of Stock Clearing Corporation that such member is in such financial or operating condition that he cannot be permitted to continue in business with safety to his creditors or the Exchange, prompt notice thereof shall be given to the Exchange. Such member shall thereby become suspended from membership until he has been reinstated as provided in Section 5 of this Article.

Suspension by Exchange for insolvency

Whenever it shall appear to the Chairman of the Board that a member firm or member corporation has failed to meet its engagements, or is insolvent, or the Chairman of the Board has been advised by the Board of Directors of the Exchange or by the Board of Directors of Stock Clearing Corporation that such member firm or member corporation is in such financial or operating condition that it cannot be permitted to continue in business with safety to its creditors or the Exchange, prompt notice thereof shall be given to the Exchange. Such member firm or member corporation shall thereby become suspended as a member firm or as a member corporation and every member or allied member who is a general partner or holder of voting stock therein shall thereby become suspended from membership or allied membership, until reinstated as provided in Section 5 of this Article.

PERTINENT RULES OF THE EXCHANGE.

Exchange Rule 325.

Operation of Member Organizations
Capital Requirements
(Rules and Policies Administered by the Department of Member Firms.)

Capital Requirements for Member Organizations and Individual Members

Rule 325. (a) No member or member organization doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 2000 per centum of his or its Net Capital, which Net Capital shall be not less than $50,000 in the case of a member organization carrying any accounts for customers and shall be not less than $25,000 in the case of any other member or member organization subject to this rule, unless a specific temporary exception is made by the Exchange in the case of a particular member or member organization due to unusual circumstances.

The initial Net Capital of a member corporation shall be at least 120% of the Net Capital required to be maintained by this rule.

The Exchange may at any time or from time to time in the case of a particular member or member organization prescribe greater requirements than those prescribed herein.

Each member or member organization shall promptly notify the Exchange if his or its Net Capital does not equal or exceed the minimum required by this rule.

Exchange Rule 325.20.

Rule 235.20 Subordinated borrowings by member organizations.—All subordinated accounts and all subordinated borrowings by a member organization—whether of cash or securities or both—where the proceeds are to be considered in the computation of net capital under Rule 325 [¶2325] must receive prior approval of the Exchange. Such borrowings may be arranged with anyone acceptable to the Board of Governors and are subject to the following provisions:

(1) Subordinated borrowings of cash

(A) The lender may be paid interest not to exceed the rate set from time to time by the Exchange.

(B) If the lender is

(i) a member of the family of one of the borrowing organization's general partners or holders of voting stock, or of a deceased general partner or holder of voting stock;

(ii) an estate of or trust established by or for one of the borrowing organization's general partners or holders of voting stock;

(iii) one of the borrowing organization's employees or the employee pension, retirement or profit-sharing plan of the borrowing organization; or

(iv) a limited partner or holder of non-voting stock of the borrowing organization

he may also share in organization profits to a reasonable extent.

(2) Subordinated borrowings of securities; subordination of equities in customers' accounts

(A) If the lender is a person listed in (1)(B) above, he may be paid interest not exceeding 8%. He may also share in organization profits to a reasonable extent.

(B) If the lender is anyone other than those listed in (1)(B) above

(i) the lender's major account shall have been with the borrowing organization for at least two years, unless the lender had not been a customer of any organization for two years.

(ii) the number of such borrowings by a member organization shall be reasonable in relation to the size of the organization, and the total dollar amount of such borrowings shall not constitute more than 25% of the total capital of the borrowing organization.

(iii) compensation for the loan or subordination of the account shall not exceed 4% on the value of the securities.

Exchange Rule 342.

Rule 342. (a) Each office, department or business activity of a member or member organization (including foreign incorporated branch offices) shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility.

The person in charge of a group of employees shall reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees related to the business of their employer and compliance with securities laws and regulations.

(b) The general partners or directors of each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities' laws and regulations. This person shall:

(1) delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control.

(2) establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.

(c) The prior consent of the Exchange shall be obtained for each office established by a member or member organization, other than a main office.

(d) Qualified persons acceptable to the Exchange shall be in charge of:

(1) any office of a member or member organization,

(2) any regional or other group of offices,

(3) any other organizational group of registered representatives.

(e) The amounts and types of credit extended by a member organization shall be supervised by members or allied members qualified by experience for such control in the types of business in which the member organization extends credit.

Exchange Rule 402.

Conduct of Accounts

(Rules and Policies Administered by the Department of Member Firms.)

Restrictions on Pledge of Customers' Securities

Rule 402. (a) No agreement between a member organization and a customer authorizing the member organization to pledge securities carried for the account of the customer either alone or with other securities, either for the amount due thereon or for a greater amount, or to lend such securities, shall justify the member organization in pledging or lending more of such securities than is fair and reasonable in view of the indebtedness of said customer to said member organization, except as provided in paragraph (d) of this Rule.

Agreements for Use of Customers' Securities

(b) No member organization shall lend, either to itself as a broker or to others, securities held on margin for a customer and which may be pledged or loaned under paragraph (a) hereof, unless such member organization shall first have obtained a separate written authorization from such customer permitting the lending of such securities by such member organization.

Restrictions on Delivery of Customers' Securities

(c) No general agreement between a member organization and a customer shall justify the member organization in delivering securities carried for the customer on sales made by the member organization for any account in which such member organization or

any partner thereof or stockholder therein is directly or indirectly interested.

Free or Excess Margin Securities

(d) No securities held by a member organization for the account of a customer, whether free or representing excess margin, may be loaned to itself as broker, or to others, or delivered on sales made by the member organization for any account in which the organization or any partner or stockholder has a direct or indirect interest unless a specific written agreement designating the particular securities to be loaned is first obtained from the customer.

Exchange Rule 417.

Financial Statements and Reports

(Rules and Policies Administered by the Department of Member Firms.)

Audit

Rule 417. The Exchange may require any member or member organization to cause to be made as of the date of an answer to a financial questionnaire an audit, by an independent public accountant, of his or its accounts and assets, including securities held for safekeeping, in accordance with such regulations as shall be prescribed and to file a statement to the effect that such audit has been made and whether it is in accord with the answer to the questionnaire. Such statement shall, in the case of each member not a partner or a stockholder in a member organization, be signed by such member and, in the case of each member organization, shall be signed by each member and allied

member thereof unless, for good cause shown, the signature of one or more of them is waived by the Exchange provided, however, that the signatures of only two members or allied members shall be required if the answer to such financial questionnaire is made available to all members and allied members of the organization. Such statement shall in all cases be attested by the auditors, and the original report of the audit signed by the auditors shall be retained as part of the books and records of the member or organization.

Exchange Rule 440.

Books and records

Rule 440. Every individual member and every member organization shall make and preserve for at least three years such books and records as the Exchange may prescribe.

Memorandum Opinion.

United States District Court, Central District of California.

Reuben P. Hughes, Plaintiff, v. Dempsey-Tegeler & Co., Inc. a Delaware corporation, Lewis Whitney, James Walraven, and New York Stock Exchange, Inc. a New York corporation, Defendants. No. 71-1299-MML.

Filed: Sept. 6, 1973.

Preliminary Statement

Plaintiff, a resident of the Central District of California, filed a complaint alleging seven causes of action based upon the Securities Act of 1933, the Securities Exchange Act of 1934, and the common law. Jurisdiction is sustained under section 22(a) of the Securities Act, 15 U.S.C. 77v(a), section 27 of the

Securities Exchange Act, 15 U.S.C. 78aa, and the doctrine of pendent jurisdiction. The first cause of action alleges a violation of section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j, of Rule 10b-5 promulgated thereunder, and of sections 12(2) and 17 of the Securities Act, 15 U.S.C. 77L(2) and 77q by Dempsey-Tegeler (Dempsey), a Delaware corporation doing business within this district, and by Lewis Whitney and James Walraven, residents of this district. The second cause of action alleges a violation of section 29(b) of the Securities Exchange Act, 15 U.S.C. 78cc(b), and of section 12(2) of the Securities Act by Dempsey, [1; 1172] and seeks rescission for the violations by that corporation alleged in the first cause of action. The third cause of action alleges a violation of section 6 of the Securities Exchange Act, 15 U.S.C. 78f, by the New York Stock Exchange (Exchange). The fourth cause of action alleges a violation of section 10(b) of the Securities Exchange Act, and of Rule 10b-5 by the Exchange. The fifth cause of action alleges a violation of section 10(b), of Rule 10b-5, and of sections 12(2) and 17 of the Securities Act by the Exchange. The sixth cause of action seeks declaratory judgment against the Exchange. And, the seventh cause of action alleges a violation of section 1710 of the California Civil Code, and of section 25401 of the California Corporation Code by Dempsey.

Defendant Lewis Whitney, a resident of this district, was an officer of Dempsey, or a general partner of its predecessor partnership, during the relevant period. Defendant James Walraven is also a resident of this district, and was employed as a registered representative and Vice-President-Branch Manager of Dempsey's office in Fullerton, California within this

district. Defendant Exchange is a New York nonprofit corporation, registered as a national securities exchange with the Securities and Exchange Commission pursuant to section 6 of the Securities Exchange Act. Plaintiff seeks damages of not less than $1.4 million, punitive damages of $250,000.00, interest at the rate of 7 percent, and costs against all defendants. Alternatively, plaintiff seeks rescission of a subordination agreement concluded with Dempsey, and the return of securities submitted pursuant to that agreement, and, concurrently, a declaratory judgment against the Exchange requiring that institution to reimburse plaintiff for his losses sustained arising out of the implementation of the subordination agreement.

General Background

Plaintiff is a college educated businessman with considerable business knowledge and experience. Approximately two decades ago, he met Walraven. At that time, Hughes was the President, and principal stockholder, of Pacific Hawaiian Products Company, the producer of [2; 1173] "Hawaiian Punch." Walraven solicited a securities account at Dempsey for the plaintiff, which advice Hughes accepted, and thereafter Walraven became his "registered representative" in his securities transactions. By the late fifties, Walraven was not only a professional consultant, but a personal friend of Hughes. At about the same time that Hughes met Walraven, he also was introduced to Whitney, then a general partner of Dempsey. Subsequently, Whitney became a director of Pacific Hawaiian. Between 1955 and 1964 there were two public offerings of Pacific Hawaiian stock, one a direct issue by the Company and the other a secondary offering by Hughes and

others. Hughes realized $2,000,000.00 from the latter transaction. Dempsey was the principal underwriter for both offerings. Following the advice of his friend, Walraven, Hughes invested $1,250,000.00 in mutual funds, later reinvesting this sum in municipal bonds.

By the spring of 1969, Pacific Hawaiian had merged with Reynolds Tobacco, subsequently named Reynolds Industries. Hughes became its largest individual shareholder, a member of the Board of Directors, and an officer of that organization. Hughes also became a director of the El Camino Bank in Anaheim, California, and of the Anaheim Stadium Corporation. In 1967, Hughes received the "Business Man of the Year Award" in Orange County. His net worth was $11,000,000.00, and his yearly income by 1969 from investments was at least $300,000.00. Although Hughes relied upon the information and advice extended to him by those associated with Dempsey, particularly Walraven, he made his own final decisions relating to the investment of his capital. Through his acquired experience, or through the application of investment counseling coupled with that experience, Hughes had engineered the growth of an interest in Pacific Hawaiian's small predecessor, a concern with an annual sales of only slightly over $500,000.00, into a combined investment and managerial position with Reynolds Tobacco, an enterprise with annual sales of slightly over $25,000,000.00. Hughes was an uncommon man, with an uncommon business acumen. [3; 1174]

Dempsey was a member organization of the New York Stock Exchange engaged in the general business of a broker-dealer, whose internal accounting practices were based upon a method of branch office reporting

to various regional accounting centers. This particular accounting operation coupled with marked deficiencies in managerial leadership were to make Dempsey particularly vulnerable to the dramatic vicissitudes which were to affect adversely the securities market in the late sixties. The implementation of internal controls by the Exchange over member firms[1] during this period was subject to criticism and to debate by both the Executive and Congress. *See* discussion, *infra*. In 1964 and 1965, the Exchange had determined that Dempsey was in violation of the Exchange's capital and record-keeping rules,[2] apparently, as a conse-

[1]The various institutions principally concerned with the control and guidance of the securities industry, the registered national securities exchanges, including the New York Stock Exchange, and the National Association of Securities Dealers, engaged in a mechanism called "cooperative regulation," by which they were charged to cooperate with the Securities and Exchange Commission in the overall regulation of the securities industry.

[2]The following discussion summarizes the Exchange's rules and constitutional provisions at issue. *Rule 325* established net capital requirements for Exchange members which, at all material times in this action, required that "no member [of the Exchange] . . . shall permit, in the ordinary course of business as a broker, . . . its Aggregate Indebtedness to exceed 2,000 per centum of . . . its Net Capital," as that latter term is defined and computed under Rule 325. Basically, net capital may be defined as the member firm's net worth less assets not readily convertible into cash (e.g., the value of seats on stock exchanges, fixed assets, etc.) The purpose of Rule 325 thus is to prevent brokers from continuing operations unless they have on hand the requisite cash or liquid assets in the required ratio to aggregate indebtedness. *Rule 325.20 (a)(B)(ii)* limits the amount of subordinated borrowings of securities allowed a member firm with "outsiders" at 25 percent or less of its total capital. Thus, this rule protects the investments of "outsiders" by requiring that "insiders," presumably privy to more intimate knowledge of the particular firm's financial and operating condition, carry the greater capital risk (e.g., for every $.25 risk taken by an "outsider," an "insider" would be risking $.75). *Rule 402(a)* establishes a requirement that the member firms segregate customers' fully-paid-for securities from all other securities owned or controlled by that member, and prohibits the member firm from borrowing on such securities in an amount

quence of its decentralized accounting system. Dempsey was unable to comply fully with the Exchange's orders that it centralize operations and reorder its accounting system, and finally, in June 1968, it requested, and received, permission from the Exchange to maintain its accounts at two separate locations. However, as late as December 1968, Dempsey continued to maintain a third accounting center in St. Louis. The St. Louis accounts substantially contributed to overall inaccuracies in the reporting of Dempsey's capital position, and these accounts still reflected inaccuracies after a subsequent transfer of the records to New York.[3]

which would be unreasonable in light of the indebtness of the customer. Under section 8(c)(3) of the Securities Exchange Act, 15 U.S.C. 78h(c)(3), such borrowings by any member, directly or indirectly, could not exceed a sum in excess of the aggregate indebtedness of customers. Rule 402(a) thus protects the fully-paid-for securities of customers, and prevents the use of such securities for borrowing or other purposes. *Rules 342 and 440* generally require the maintenance of accurate books and records so as to insure a source of information fairly reflecting the financial and operational status of the firm for customers, investors and the general public. And *Rule 345* provides for disciplinary proceedings against member firms who violate the Exchange's rules. *Article XIII, Section 2 of the Exchange Constitution* provides that whenever it should appear to the Exchange that a member "has failed to meet his engagements [i.e., contractual obligations] or is insolvent, or . . . in such financial or operating condition that he cannot be permitted to continue in business with safety to his creditors or the Exchange, . . . [s]uch member *shall* thereby become suspended from membership. . . ." (emphasis added.) *Article XIV, Section 6 of the Exchange Constitution* provides that the Exchange, after determining that a member was in violation of the Exchange Constitution or of any rule promulgated thereunder, or that a member has engaged in conduct inconsistent with just and equitable principles of trade, may suspend or expel the member. And *Article XIV, Section 14 of the Exchange Constitution* provides for disciplinary proceedings against member firms in instances of violative conduct except that such proceedings are not required where a member has entered into a consent to penalty with the Exchange.

[3]"Statement of Facts, Charges and Consent to Penalty and Offer of Settlement—Jerome F. Tegeler," October 22, 1969 (at page 3 of Statement of Facts attached thereto). Exhibit No. 33.

Haskins & Sells, certified public accountants, conducted several audits of Dempsey for the Exchange prior to and during the member organization's crisis period. The surprise audit for 1968, received by the Exchange on January 16, 1969, revealed serious capital and accounting problems in violation of Exchange rules. Dempsey's net capital deficiency at the time of the audit was $1,029,492.00, which was in violation of Rule 325, the Exchange's net capital requirement rule. Its interoffice balances reflected a debit of $2,543,-044.00, with securities long in the amount of $3,-272,784.00, and securities short in the amount of $17,-452,478.00. Unresolved "long security count differences" were in the amount of $18,363,753.00, and unresolved "short security count differences" [4; 1175] were in the amount of $2,631,817.00.[4] Improperly maintained, unsegregated customer securities amounted to $21,917,-991.00, which amount included $3,784,374.00 erroneously pledged by Dempsey for its own borrowings. These accounting errors were centered principally in the New York office, where there was a conceded absence of competent supervision and direction.

Consequently, the Exchange invoked a measured response against Dempsey by levying certain sanctions against its business and management. Whether this response was adequate under the circumstances is one of the major issues of this case. *See* discussion, *infra*. The Exchange placed restrictions on Dempsey prohibiting it from advertising or adding registered representatives, limiting the maximum number of weekly trades,

[4]"Long security count differences" indicate securities the owners of which a particular firm is unable to identify and locate. "Short security count differences" indicate securities the owners of which are identifiable, and locatable, but the firm is unable to locate the securities themselves.

and requiring an immediate infusion of new capital. Consequently, Dempsey obtained $14 million in subordinated capital from the Dempsey partnership, most of which consisted of common stock in Siboney Corporation. This stock was unregistered, and therefore not freely tradeable, nor was it entitled to be treated as capital under a strict construction of Rule 325 of the Exchange. However, the Exchange determined, in a discretionary interpretation of Rule 325, that Dempsey could be given capital credit for this stock, and that the restrictions imposed against that firm could be lifted. The exercise of this discretion necessarily involved the interpretation of the Exchange's Constitution, which established broad powers for discontinuing the business of a firm which became a risk either to its creditors, or to the Exchange itself.[5] *See* discussion, *infra*.

The Exchange also moved against Dempsey's top levels of management, bringing an action against Dempsey and certain of its officers, which eventually resulted in a consent to penalty and an offer of settlement, including the levying of a $100,000.00 fine upon Dempsey, a $50,000.00 fine upon Jerry Tegeler, President and principal director of Dempsey, and a $5,000.00 fine upon Albert Gummersbach, a senior Vice-President of the firm. Placed upon a restrictive basis, Dempsey was required to resolve its accounting and record-keeping problems by September 30, 1969 [5; 1176] under penalty of further reduction of its business by the Exchange, or removal from Exchange membership.

Haskins & Sells commenced its 1969 audit on June 1st, and, on September 18, 1969, it issued its status

[5]*See* note 2, *supra*.

report of Dempsey as of the first of June. The audit pointedly avoided the issuance of an unqualified opinion with respect to Dempsey's financial condition. The June 1st audit indicated that Dempsey's net capital deficiency had increased to $1,127,000.00; *however* this computation included credit for 70 percent of the value that the Siboney stock would have had if it had been registered and tradeable. If the Exchange had not determined, through the exercising of its discretion, to allow this stock to be utilized for capital computation purposes, Dempsey's net capital deficiency would have been $9,305,000.00. Dempsey's interoffice debit balances had increased to $4,331,000.00, with securities long raised to $5,321,000.00 and securities short raised to $4,480,000.00. Its unresolved "long security count differences" had decreased to $10,878,000.00 and its unresolved "short security count differences" had increased to $12,064,000.00. The amount of improperly pledged customer securities had increased to $9,034,000.00. In addition, the June 1st audit revealed that Dempsey now had "fails to deliver,"[6] to unidentifiable purchasing brokers, in the amount of $11,206,433.00 (debit balance) at a market value of $8,445,884.00 (long security valuation, with no short valuations indicated.) Further, Haskins & Sells was unable to confirm the existence of securities with the approximate market value of $7 million dollars, allegedly held by transfer agents, since replies were not received to requests for confirmation. As of June 1, 1969, Dempsey's unresolved "short stock record differences" (also known as "short security count

[6]These are securities of a particular amount, under a contract providing for a predetermined settlement date, which for one reason or another a selling broker is unable to deliver.

differences," *see* discussion and note 4, *supra*) exclusive of subordinate borrowings were 213.46 percent of its stated net worth, the worst in the industry, and placed that firm perilously close to insolvency in the event such differences were incapable of being resolved.[7]

In August 1969, the Exchange independently arrived at the same conclusions as Haskins & Sells as a result of an analysis of Dempsey con- [6; 1177] ducted by its own examiners—in effect, that Dempsey's records, financial and operational reports, and net capital computations were all inaccurate. Senior Exchange officers and Commissioners had met with their staffs in liaison meetings over six-week intervals during this period. Congressional and Commission interest in the stability of the brokerage industry had also been incited earlier during the late spring and early summer of 1969. On June 9, 1969, a bill was introduced in the Senate providing for a Federal insurance program for the protection of brokerage customers, and a similar bill was introduced in the House of Representatives at about the same time.[8] Subsequently, Congress called upon the Commission to take a position on such a Federal customer protection program. This question of protection became a recurrent topic of discussion in the Exchange-Commission liaison meetings, specifically concerning the pivotal issue whether the Exchange's trust fund would become available for customers of the mem-

[7]"Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendations of the Securities and Exchange Commission," H.R. Doc. No. 231, 92d Cong. 1st Sess. 102 (1971) (SEC "Unsafe Study"); *see* 15 U.S.C. 78kkk(h); *see also* discussion, *infra*.

[8]*See for example*, S. 2348, June 9, 1969, "A Bill to establish a Federal Broker-Dealer Insurance Corporation" (introduced by Senator Muskie).

ber firms under examination in the event of a final crisis, and whether bankruptcy and receivership of such firms would affect subsequent access to the fund.

These facts merely serve as a prelude to the principal events leading up to the execution of the Hughes subordination agreement; to the constant posturing between the Commission and the Exchange subsequent to the summer of 1969; and to the deceptive revitalization of Dempsey through the influx of subordinated capital, which only forestalled its eventual demise and liquidation in August 1970. A more detailed discussion of these events follows.

The August 1969—August 1970 Period.

The crucial events in this period involve three broad topics, separable primarily for purposes of discussion, but intimately related in terms of mutual impact: (1) the negotiations between Hughes and the Dempsey executives, principally Walraven and Whitney, but subsequently including another important figure; (2) the communications between the Exchange and the Commission on the general subject of member firm controls, in particular Dempsey; and (3) the capital accounting state of [7; 1178] Dempsey, of which a true picture never emerged during the critical period, notwithstanding the efforts to all concerned parties.

Early in 1969, Walraven approached Hughes and suggested that he subordinate a substantial portion of his securities to Dempsey, which securities were comprised mainly of municipal bonds, in order that the firm could utilize them as additional capital in meeting the Exchange's net capital requirements. This was posed as a highly profitable venture for Hughes since he would be paid a base interest for the loaned securities,

while simultaneously retaining the dividends and interest payable on the face of those securities. Hughes continued meeting with both Walraven and Whitney into the fall of 1969. In response to such suggestions from these two trusted friends and business associates, Hughes initiated an independent inquiry into the necessary mechanics of subordinating his securities to Dempsey. To this end, he directed his personal lawyer to research the details of the proposed subordination agreement, and the capital structured of Dempsey before and after the proposed addition of his securities.[9] Hughes was advised to await the return of the Haskins & Sells audit of June 1969, and it was agreed between Hughes and Dempsey to stay further discussion until the fall of 1969.

Haskins & Sells released its June 1st audit on September 18, 1969. Hughes received this audit at about the time of the release, and had it in his possession at all subsequent, relevant times. Hughes conceded that the "fails to deliver" to unidentifiable brokers in the amount of $11,206,433.00 was a "very significant and substantial sum for Dempsey-Tegeler." Hughes also admitted that the discrepancy of about $1,200,000.00 between the value of securities on hand for which there was no record accountability, and the value of recorded securities which could not be accounted for was also a significant sum. And yet, Hughes represented that he was not apprised of the significance of these figures, or of the implication underlying Haskins & Sells' withholding of an opinion as to certain specific matters (including receivables from brokers and dealers

[9]His securities counsel at that time had represented Hughes in two prior Pacific Hawaiian offerings, and had been his personal attorney on all matters for the past twenty years.

on "fails to deliver;" reserves for possible specified losses; and capital [8; 1179] stock and surplus) because whenever he referred to that audit he failed to carefully examine the details of the statement. Hughes' explanation for this omission was that he was not sufficiently motivated to put on his reading glasses. This offered explanation for failure to discover such crucial information at this point in time is suspect in light of two key inferences: (1) Hughes' reputation as a man of good judgment, and his experience as a successful businessman; and (2) the substantial commitment of Hughes' reliable municipal bonds to a subordination scheme which, at the very least, demanded an attention to detail commensurate with its potential for risk. In rebuttal to these assumptions, Hughes contended that he relied substantially upon the *oral* representations made to him by Walraven and Whitney at various times up to, and including, the date of the final subordination agreement. *See* discussion, *infra*.

Late in 1969, Dempsey began negotiations with John King, chief executive and primary stockholder in King Resources Corporation, a holding corporation with substantial assets. King initiated an in-depth investigation of Dempsey by a team of accountants and attorneys toward the view of making a subordinated loan to Dempsey in the amount of $7 million to be secured by King Resources' stock. King's investigations and negotiations were closely watched by the Commission.[10] King initially insisted that, as a condition of

[10]The Commission was supplied with the initial drafts of the proposed King loan documents in a letter dated January 27, 1970 from Paul Chenet of the Exchange to Charles Hartman. Exhibit AN. Also, Mr. Cunningham, in a letter dated February 10, 1970, reported further progress with respect to the King loan. *See also* discussion, *infra* at 13-16.

his loan, the Exchange first would have to lift the restrictions on Dempsey, thereby enhancing its immediate potential for growth, and it subsequently would have to certify that Dempsey would be in compliance with its net capital requirement rule. The Vice President of the Exchange's Department of Member Firms, Robert Bishop, refused to accept these conditions. Notwithstanding these lack of assurances, King went forward with his subordination, on or about March 19, 1970, on the condition that the Exchange, with the acquiescence of the Commission, would *then* lift its restrictions on Dempsey's underwriting business. King thereupon executed demand notes for approximately $7 million, which were secured by King Resources stock held in escrow with a market value of approximately $10 million. The Commission advised the Exchange that the King stock was [9; 1180] marketable, and thus qualified as capital of Dempsey, whereupon the Exchange then gave Dempsey the requisite capital credit.

The King negotiations were also closely watched by Hughes. In December 1969, Hughes was invited to the first of three meetings in Walraven's office to discuss the feasibility of Hughes subordinating his securities to Dempsey. Whitney was also present at these meetings, and, at this time, he advised Hughes not to commit himself unless King followed through on his subordination. Whitney outlined the mechanics of subordination for Hughes at this first meeting. Hughes' execution of the subordination agreement would transfer the securities in his account to Dempsey's capital account, but Hughes would continue to recover interest, dividends and distributions on such securities, plus interest payments at one-half of 1 percent above the prime rate of First National City Bank. This latter rate

of interest would realize an additional income to Hughes from the securities in the amount of $80,000.00. At this time, Hughes knew that the subordination would subject his securities to creditors' claims, and that there were dangers involved in this venture. Hughes also was apprised of Dempsey's accounting problems, and of the difficulty with the leadership in the New York office.[11] However, Hughes was impressed with King's position on Dempsey, and admitted to relying upon King's business judgment in considering subordination of his own securities.

In the period between the release of the Haskins & Sells' audit of September 1969 and the first Hughes-Dempsey meeting of December 1969, the Commission and the Exchange were becoming increasingly aware that the earlier disciplinary action taken against Dempsey (the consent to penalty and offer of a settlement, *see* discussion, *supra*) were not working. At a meeting in New York on September 25, 1969, between agents of the Commission, officers of the Exchange, and representatives of Dempsey, the substantial noncompliance of Dempsey with past directives to centralize procedures, remedy deficiencies in accounting, and to take

[11]Hughes was a subscriber to the *Wall Street Journal* for many years. He reads to keep abreast of financial developments, particularly with respect to news of his competitors. Hughes testified on cross-examination that he was not sure whether he had noticed news items pertaining to the suspension of Mr. Tegeler from the Dempsey management, which items indicated that such suspension was a direct consequence of that firm's accounting difficulties dating back to 1968. Hughes testified that he did not recall the specific amount of fines levied against Mr. Tegeler, that he did not know that the firm had been censured and that he did not know the effect of the term "censured" in this respect. Hughes testified that the omission of an opinion by independent accountants about key aspects of the firm's financial status would not have affected his subsequent decision to subordinate his securities. *See* discussion, *infra* at 17-19.

corrective action with respect to capital balances was disclosed in a letter written by [10; 1181] Mr. Robert Haack, the President of the Exchange. It became rather apparent at this time that not only would Dempsey be unable to comply with the formerly imposed September 30 deadline, but that it was quite uncertain when, if ever, Dempsey could submit a statement that appropriate corrective measures were being implemented, and were reflecting successful results. Mr. Tegeler for Dempsey admitted that he had underestimated the gravity of Dempsey's difficulties. Mr. Bishop for the Exchange demonstrated a firm attitude against a subsequent extension of the September 30 deadline beyond October 3rd, 1969. And Mr. Sporkin, Associate Director of the Division of Trading and Markets for the Commission, registered an increasing concern for the failure of Dempsey to keep his office fully apprised of that firm's on-going efforts to define, and check, its difficulties. The Commission's concern became amplified in late October 1969. At a second meeting between the Exchange and Commission representatives on October 24, 1969, strong disagreement over the handling of the Dempsey problem emerged. Mr. Hurd Baruch, Special Counsel for the Commission's Division of Trading and Markets, testified to conflict between Mr. Sporkin and Mr. Cunningham, Executive Vice-President of the Exchange (the officer in charge of the liaison program with the Commission which had originated in late spring 1969) on the questions of the propriety of injunctive action being taken to shut Dempsey down, of the appointment of a receiver, and of an immediate curtailment of the solicitation of new business.[12] The precise area of dispute concerned Dempsey's continuing

[12]Mr. Baruch demonstrated bias against the Exchange for its unwillingness to move more decisively against Dempsey early in

(This footnote is continued on next page)

violation of the Exchange's net capital rule, the nature of control over Dempsey which the Exchange was willing to exercise, and the availability of the Exchange's trust fund to Dempsey customers in the event of Dempsey's collapse. In the end, the Exchange prevailed; Dempsey was not to be suspended. However, further restrictions were to be imposed. The Chairman of the Commission, Hamer Budge, demanded a course of action from the Exchange, in writing as to its immediate handling of the Dempsey problem, and as to the availability of the trust fund for Dempsey customers. It is quite evident [11; 1182] that the Commission's independent research efforts into Dempsey's difficulties, as well as those of other member brokerage houses, resulted in its conclusion that very serious difficulties existed with respect to its internal management, accounting, and capital requirements. However, that regulatory body eschewed the invocation of *any response* under the statutory powers readily available to it under these circumstances, and acquiesced in the face of representations by the Exchange that Dempsey's difficulties were neither irreparable nor unmanageable, and that it could meet such difficulties sufficiently to curb the downward trend.[13] Thus, a "gentlemen's

the action long before the stopgap restrictions finally were revealed as generally inadequate. This bias was taken into consideration in determining the weight to be given to his testimony. Some of Mr. Baruch's insight can, and should be, attributed to hindsight; however, apart from this, his observations proved to be fairly accurate on the Dempsey question. Of course, the Exchange's order of priorities differed—it was concerned with the viability of the securities market as a whole—and not merely with one aspect which focused concern on the management of brokerage houses. Whether the Exchange's assignment of priorities was defensible is one of the major issues of law in this action. *See* discussion, at 21-46 *passim*.

[13]This was an implied recognition of the Exchange's broad discretionary powers. *See* discussion and note 2, *supra*. The

agreement" was arrived at by which the Exchange would seek to order its organization in its own fashion, without "official" pressure from the Commission.

Events subsequently demonstrated that *both* the Commission and the Exchange erred in their estimations and predictions. Upon first learning of the Dempsey problem, the Commission was placed in a difficult dilemma—Dempsey was not meeting the net capital requirement of the Exchange, and the Exchange had lowered its restrictions enabling Dempsey to maintain a newly established minimum liquidity. The Commission became justifiably concerned whether Dempsey could overcome the slowly emerging legacy of the accounting and managerial deficiencies to survive increasingly mounting pressures from owners of securities and from general creditors. Thus, receivership became an alternative with respect to solving, singularly, the Dempsey problem. However, the Exchange reminded the Commission that the imposition of a receivership upon Dempsey could raise vast implications for the brokerage industry as a whole in terms of public confidence in the market. A general crisis was likely with the potential revelation of similar overextensions on the part of other houses, which could be compounded by

relatively passive posture adopted by the Commission in this instance has a procedural source in the Commission's own net capital requirement rule, which sets forth minimum requirements for brokers, but which provides an exemption for some of them including "any member in good standing and subject to the capital rules . . . of the New York Stock Exchange . . . whose rules, *settled practices and applicable regulatory procedures* are deemed by the Commission to impose requirements *more comprehensive* than the requirements of this rule." SEC Rule 15(c)(3)-1(b)(2): *see* 17 C.F.R. §240.15c3-1(b)(2) (1973) (emphasis added). The presumption on the part of the Commission, of course, was that given "more comprehensive" self-regulatory tolls, the Exchange would be fully utilizing same. This presumption did not bear fruit in this case.

the absence of income generation in the face of an inevitable, public loss of confidence. And, if Dempsey were thrown into receivership, under the management of the Commission, the Exchange indicated it would exercise its discretion in withholding trust funds which might have been otherwise available in an [12; 1183] Exchange-controlled liquidation setting. Thus, the Commission's statutory options were confounded beyond visible resolution by events intially vaguely understood, and ultimately irrevocable in effect, and the Exchange's choice of alternatives was similarly narrowed by the burgeoning inertia of its past decisions. Aside from these broader problems of policy, the relatively narrow question raised at this juncture is the propriety of the Exchange's discretionary encouragement of Dempsey to seek new, subordinated capital to meet an already previously modified net capital requirement and to provide desperately needed operating capital for short-term demand, in the face of the ever increasing likelihood of an eventual total liquidation which might completely absorb such subordinated capital.

On December 11, 1969, yet another inconclusive meeting was held between representatives of the Commission and the Exchange. Mr. Sporkin continued to express undisguised concern over Dempsey noting that, in the judgment of the Commission, three brokerage houses including Dempsey, were in imminent danger of collapse. Mr. Cunningham refuted these assessments on behalf of the Exchange. He acknowledged some problems, but asserted that the Exchange had them under control, and was taking measures to improve the difficulties. Specifically, the project to raise subordinated capital for Dempsey was mentioned in the context of the Exchange's suggestion that the Commis-

sion refrain from taking any action lest efforts to solve the capital deficiency problem be thwarted. The net effect of the Exchange's interpretation of the Commission's role vis-a-vis the Dempsey problem seemed to be that of a regulatory body of necessity relegated to the position of a formally and intensely interested, but essentially nonfunctional bystander.[11]

Notwithstanding this relatively ineffectual role for the Commission, it was kept somewhat apprised of the events between December 1969 and March 1970 which led up to, initially, the King, and then the Hughes subordination. On January 16, 1970, Chairman Budge requested a "full report" from Mr. Haack as to the "financial condition" of certain Exchange members. He also requested that Exchange staff members confer with [13; 1184] Mr. Kevin Duffy, the Commission's Regional Administrator in New York City, and with Mr. Sporkin to "fully explore" such problems. Mr. Cunningham responded to Chairman Budge on behalf of the Exchange, on January 20, 1970, noting that Mr. Duffy and Mr. Sporkin had met and conferred with Mr. Bishop and other Exchange officials as to those firms with significant business losses in the first half of 1969. Mr. Cunningham represented that these men had been meeting "every second or third day during the past several weeks" to confer on those firms with "immediate problems." On February 10, 1970, Mr. Cunningham sent a written report pursuant to Chairman Budge's request which, in substance, revealed that the resolution of Dempsey's difficulties was proceeding slowly, with particular difficulty arising with respect to

[11]Congress appeared to be disturbed by this apparent status of the Commission. *See* note 1, *supra*, and note 29, *infra*.

the establishment of Dempsey's true position on "fails to deliver." This report also noted that a final draft of the King agreement was imminent, and that Mr. Robert Peck, an accountant who had just reduced certain difficulties at Hayden Stone, had joined Dempsey (in response to Whitney's solicitation) to assist in accounting research and clarification as its Executive-Vice-President-Finance. Upon his appointment, Mr. Peck immediately embarked upon a detailed reorganization effort which, based upon certain crucial assumptions, would resolve Dempsey's profitability problems by October 1970.

The Commission was supplied with the initial drafts of the King loan agreement, and, on February 19, 1970 at a Commission conference, representatives of King, the Commission, and the Exchange met to discuss the particular requirements of each of the three participants which had to be resolved prior to entering into the subordination. These requirements included, inter alia, a detailed analysis of Dempsey's earnings certified by a competent financial officer; an outline of Dempsey's earnings certified by a competent financial officer; an outline of Dempsey's financial future by a competent officer projecting income and expenses for twelve months, and indicating the basis for the assumption that Dempsey could break even with a new interest factor load of $60,000.00 per month; an analysis of measures to be taken to correct bookkeeping deficiencies with a time estimate as to compliance therewith, and an estimate as to possible sanctions to be [14; 1185] levied by the Commission; and, an estimate of when the registration of the Siboney stock would become effective, and of the percent of its market value which the Exchange would allow as subordinated capital.

Following this meeting, the Commission expedited the registration of King's stock with the knowledge that it would be used for the Dempsey subordination. As of the date of the King registration, February 27, 1970, Dempsey's operational problems reflected an increase in "short securities count differences" ($28,004,331.00 over $12,064,000.00), an increase in securities pledged in error ($12,668,066.00 over $9,034,000.00) and an increase in "fails to deliver" in the unidentifiable brokers' account ($12,977,173.00 over $11,206,-000.00)[15] over available, similar figures reflecting the capital condition as of June 1, 1969. The Exchange did not receive this report until after March 26, 1970 —after Hughes' subordination entered into force. However, prior to March 19, 1970, the Exchange's examiners determined that Dempsey, as of February 27, had a net capital deficiency of $17,909,857.00 based upon a ratio of aggregate indebtedness to net capital of 2000 percent. (Based upon the more stringent ratio of 1750 percent, which had been previously imposed pursuant to Rule 325 on September 24, 1969, Dempsey's net capital deficiency was in the amount of $18,-386,744.00).

King had sought language in the loan agreement that his loan was contingent upon the Exchange's certification that Dempsey was in capital compliance, and upon the Exchange's willingness to rescind most of the restrictions. The Exchange expressly rejected this condition precedent to the King subordination. The position of the Exchange was that Dempsey would at-

[15]This increase in "fails to deliver" does not reflect Dempsey's adjustment as of April 1970 for bank overdrafts as of December 1968. *See* note 21, *infra.*

tain compliance *after* the infusion of the King and Hughes capital, which would stimulate confidence, and *after* the lifting of the restrictions upon Dempsey's capabilities to conduct its underwriting business,which would stimulate expansion. This policy, and speculation, was expressed in correspondence on March 19, 1970 between Mr. Bishop and Mr. Whitney. With this knowledge and understanding, King went forward with his subordination. He executed demand notes on March 19, 1970 for approxi- [15; 1186] mately $7 million secured by King Resources' stock. *See* discussion, *supra*. The Exchange lifted its restrictions on March 24, 1970. Assuming capital credit for the King securities, Dempsey's net capital deficiency at this point in time was $10,241,000.00. However, since the King stock was "control" stock, technically Dempsey was not immediately entitled to apply it for purposes of capital credit. Because the King stock had been only "shelf registered," certain post-effective amendments had to be filed with the Commission prior to any public sale. These were never filed prior to the King subordination, therefore, technically the King securities were not freely tradeable, and were consequently, improperly awarded treatment as "available" capital. Accordingly, after Hughes' subordination on March 24, 1970 based upon King's commitment of his stocks, Dempsey's actual net capital deficiency was $17,241,-000.00. At this point, a regression to Hughes' negotiation with the Dempsey executives, and subsequent contacts with the Exchange is appropriate.

In February 1970, Hughes met with Walraven and Whitney a second time. A subordination agreement was proposed to Hughes, which was patterned after the proposed King subordination agreement being dis-

cussed in Washington at that time between the Commission, the Exchange, and the King representatives.[16] Hughes was particularly impressed with the fact that King was considering a substantial subordination of securities to Dempsey. (He had realized extensive profits earlier from investments in King stock.) Hughes authorized extensive negotiations between his securities counsel and Dempsey's outside counsel in St. Louis over the nature and structure of such a subordination agreement. The agreement proposed to Hughes would award him (and other "outsiders," like King) priority over the purported "insiders" (Dempsey stockholders who had subordinated loans, including Whitney). Whitney represented to Hughes that it appeared that King would decide to subordinate if all restrictions were lifted, and if the "Omega situation" could be resolved.[17]

[16]At this meeting, Dempsey's "operating problems" were specifically raised and discussed. Hughes learned that the "biggest" difficulty lay in Dempsey's "record keeping," and that the essential problem was in the requirement imposed by the Exchange that Dempsey centralize its accounting in New York City, or in some other acceptable location, which was very difficult to comply with since Dempsey could not hire adequately experienced personnel to implement such measures. However, Hughes was told that Dempsey was "doing a big volume of business," that Dempsey was a "viable corporation," and that Dempsey would be able to demonstrate these facts once it could "straighten out the back-office problem." The restrictions imposed by the Exchange were also specifically discussed. Hughes was told that the Exchange required Dempsey to close some of its offices, and to reduce part of its staff in order to streamline operations, and that Dempsey was in "technical violation" of the Exchange's rules setting minimum capital requirements in relation to the amount of business being transacted. Hughes was told that Dempsey was "doing more business than they had capital to back up," and that that was the reason for wanting the subordinated capital from him and King.

[17]Whitney indicated that he would leave soon for Washington to discuss with the Commission the possibility of resolving, at a private hearing, the Commission's investigation of Dempsey's conduct in relation to the securities of Omega Equities Corporation.

At approximately this time, Whitney renewed his own subordinated loan to Dempsey in the amount of roughly $485,000.00 (which amount reflected nearly [16; 1187] 90 percent of his net worth). (His sister also subordinated capital to Dempsey in the amount of approximately $400,000.00.) However, under the terms of his particular agreement and the rules of the Exchange, Whitney was free to withdraw his funds.[18]

The third and final meeting between Hughes, Whitney and Walraven occurred on March 23, 1970—one day prior to the date of Hughes' execution of his subordination agreement. Mr. Peck was present at this meeting. (Mr. Slavek Uhlir, another accounting expert employed by Dempsey who was assisting with its record-keeping and operations problems, was also present.) At this meeting, Walraven and Whitney, either jointly or individually, represented to Hughes that subordination of his securities to Dempsey was a good idea; that the probability of a loss was remote; and

[18]Whitney never exercised these options, and eventually he sustained extended personal losses. In addition to his "insider" subordinated loan, he lost a 5 percent interest in partnership securities, and $200,000.00 in direct cash contributions to Dempsey, thus resulting in a total personal loss of about $700,000.00. (Whitney's sister also lost her subordinated capital in the amount of $400,000.00). Whitney emerged as Dempsey's chief executive officer in October, 1969. He brought Peck into Dempsey specifically to devote exclusive, initial efforts toward the resolution of both accounting and operations problems, after which he would devote his principal efforts to the operations area. Prior to Whitney's elevation in the firm, he was responsible for the West Coast operations centered in Los Angeles, which branch office had a reputation, both within Dempsey itself and within Haskins & Sells, for minimizing the difficulties experienced in Dempsey's other branch offices. Thus, paradoxically, that very characteristic which enervated Dempsey nationally in terms of public image-decentralization—enabled Whitney to maintain a relatively strong regional center in Los Angeles. Whitney thus inherited Dempsey's problems in general—he certainly did not generate them from Los Angeles.

that they, as long-standing friends and trustworthy business advisors, would not suggest subordination to him if they seriously believed that he would suffer losses as a result. Neither Walraven nor Whitney were accounting specialists, and Hughes was fully aware of that fact. Walraven and Whitney conveyed an optimistic appraisal of Dempsey's dilemmas, emphasizing apparently meaningful progress in resolving record-keeping and operations problems; deemphasizing the *import* of such record-keeping and operations problems by suggesting that they were caused in part by the Exchange's imposition of restrictions, which merely cut down Dempsey's profitability margin in underwriting; misconstruing Dempsey's true capital state (by no means a unique error in this case); and misplacing the final effect of the expected King subordination by suggesting that it alone was sufficient to cure Dempsey's capital plight.[19] It is patently obvious that neither Walraven nor Whitney knew of the substantially weak position of Dempsey, or of the full extent of the accounting errors, which, in turn, precluded a presentation of a true picture of Dempsey's capital structure. However, Peck also had Hughes' undivided attention at times during this third meeting.

Peck presented an array of documents, which, if closely examined and given careful thought, would

[19]Hughes was told by these two men that Dempsey had been able to reduce its capital deficiency by about 15 million dollars (reducing the deficiency from 23 million to five million dollars.) He was told that there was a possibility that he could lose his money, but that it was not very "probable." He recalled Walraven saying that he would not let Hughes "go into this thing if I thought you were going to lose anything." During that meeting, and even prior to this meeting, Walraven had offered the suggestion of Hughes arranging to meet with King, the latter's private

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have at least raised serious [17; 1188] questions and doubts far more substantial than those engendered by Walraven and Whitney's representations.[20] Peck offered Hughes his assessment of Dempsey's contemporary accounting and capital state, including the import of its stock record differences, "fails to deliver," and intercompany accounts.[21] Most critically, Peck offered

plane apparently being accessible to Hughes for this purpose. Hughes was not told that Dempsey was insolvent, or close to insolvency.

[20]These included: (1) Dempsey's financial statement as of June 1, 1969; (2) Dempsey's comparison of capital charges; (3) Dempsey's interoffice correspondence from John Ellis to Whitney of February 23, 1970; (4) Dempsey's profit plan of February 20, 1970; (5) Dempsey's "Registered Representative Status"; (6) Dempsey's income and expense projections; (7) Dempsey's progress report contained in a letter from Whitney and Mr. Peck to Mr. Sporkin on March 9, 1970; (8) Dempsey's schedule of its problems, and Mr. Peck's proposed plan for resolving them (also contained in the letter of March 9 to Mr. Sporkin); (9) Dempsey's organization chart, (also featured in the March 9 letter to Mr. Sporkin); and (10) a statement containing certain data which was a pro forma balance sheet reflecting Dempsey's financial position as of February 27, 1970. Hughes was also presented with the various documents needed to consummate his subordination. *See* discussion, *infra; see also* note 21, *infra.*

[21]Peck read the March 9, 1970 letter to Mr. Sporkin, amplifying upon the technical terms contained therein. Peck projected that, in the coming eight-month period ending in October 1970, he planned to reduce the suspense items by $1,800,000.00 per month in short differences, and, by October 1970, have remaining short differences and suspense items in the amount of $4 million. He also projected that the intercompany accounting problem could be reduced at the rate of $1,500,000.00 per month starting in April 1970, and could be completed in October 1970. (With respect to these projections and others, Peck subsequently achieved the progress which he had contemplated in most of the areas.) Peck pointed out to Hughes that 1968 had been a profitable year, but that 1969 reflected losses—specifically, operating losses in January 1970 or $876,000.00. He projected that losses would continue through to and including October 1970 so that not until November 1970 could he project Dempsey operating at a profit. Peck specifically discussed the capital state of Dempsey as reflected in the pro forma financial data statement as of February 27, 1970, noting that, even after the King and Hughes

Hughes his professional opinion that a doubling of the firm's income was required to break even on Dempsey's accounts, and that such a projection of breaking even was founded upon the basic premise that Dempsey would encounter renewed growth (e.g. expansion in the sales force) which, in turn, was further premised on the even more fundamental factor that general market conditions would have to improve. Peck carefully pointed out that if these premises became endangered, he would have to revise his projections. Peck further advised Hughes that Bishop had refused to extend the Exchange's certification of Dempsey's capital compliance prior to King's execution of his subordination.[22] *See* discussion, *supra*. Peck expressly disagreed with Walraven and Uhlir's optimistic assessments of Dempsey's operational trends, and flatly told Hughes that there was a "good chance" that he would lose his money if he went ahead with the subordination. In addition to these admonitions by Peck, Hughes, prior to this third meeting, had been informed as to several background events which, cumulatively at least,

loans, Dempsey would have a capital stock and surplus of only a little more than $2 million. At this point, Peck physically handed the pro forma statement to Hughes. During this discussion, Hughes learned that Dempsey's earlier computations revealed a deficit of about $5 million, that Peck estimated potential additional capital charges, over and above that $5 million deficit, in the range between $6 million and $16 million, and that Peck also had discovered, on the eve of this meeting, an error in the reconciliation of the bank statements in the amount of about $5 million, consisting primarily of two substantial checks which had never been recorded in the books. Therefore, Hughes was on notice that as to potential additional financial charges, Dempsey faced a *potential* capital deficiency of over $26 million.

[22]It was mentioned at this meeting that Dempsey's usage of the Siboney stock was limited by the Exchange—that the Exchange would not allow that stock to be used for capital computation purposes. Hughes had specific knowledge of the restricted use of the Siboney stock.

suggested that extraordinary caution was merited.[23] In closing, Peck offered to elaborate upon the data which he had revealed to Hughes at this third, and final, meeting. Hughes did not request further explanations. He gave no indication that he did not understand that which Peck had related to him, and Peck concluded that Hughes understood everything which Peck had communicated to him. In light of the nature of the information offered by these three sources, which Hughes could have given equal weight, and, particularly in light of the different roles each of these advisors played prior to and during this meeting, it is not an unreasonable inference to conclude that, in the final analysis, Hughes simply followed that advice which he wanted to hear. And, he wanted to believe that subordination would be fruitful, and not based upon a substantial risk. In [18; 1189] this sense, Hughes alone was to blame for his losses, for the signals of potential disaster were pregnant in Peck's statements. Hughes just either dismissed them lightly, or decided to ignore them entirely.

[23]Those background events of which Hughes had prior knowledge were that: Dempsey was generally plagued with back-office paperwork, reflecting its subpar record-keeping of transactions (which resulted in the Exchange's requirement that it centralize its accounting department in one location); Dempsey was having difficulty hiring adequately experienced personnel to operate its accounting department; the Exchange had directed Dempsey to close some offices, reduce its staff, and not hire any more registered representatives; Dempsey was overextending its business (i.e. it was doing more business than it had capital to back up); Peck, an operations expert, had been directed in early 1970 to take over the New York situation, and straighten matters out; Tegeler had been suspended by the Exchange for one year, and had also been fined for mismanagement; and Hughes had been previously informed by his contemporary securities counsel that the effect of the subordination agreement, as contemplated and ultimately executed, would expose his subordinated capital to the representatives of Dempsey's creditors in the event of a situation calling for their financial protection.

After the meeting, Hughes took the documents home with him. Whitney told him to confer with his securities' lawyer, and to await Whitney's notification that the King loan had been consummated and that the restrictions against Dempsey had been lifted. After notice of these events, Hughes executed the appropriate documents on March 24, 1970, including the subordination agreement of that date;[24] a subordination agreement dated January 20, 1970;[25] a "knowledgeability letter" addressed to the Exchange;[26] and a document required by the Exchange for its approval of Hughes as a subordinated lender to a member organization.[27] Hughes returned all documents to Whitney, except the "knowledgeability letter," which he mailed directly to the Exchange.

Shortly after the King and Hughes subordinations of March 1970, the entire stock market plummeted. The New York Stock Exchange Index declined by approximately 25 percent, the American Stock Exchange and over-the-counter averages declined by substantially greater amounts. The stock securing the King loan dropped from $23 per share in March 1970 to approximately $6 per share at the end of May 1970. On April 30, its market value had been $5.5 million ($14 per share); by May 22, its net value had declined to $2.7 million. By July 1970, there was no market for the King stocks, the market value had fallen to $1.50 per share.[28] The precipitous decline of the stock market in general, and the King stock in particular, was disastrous for Dempsey. It not only reduced the value of the securities constituting Dempsey's capital position, but it also limited Dempsey's ability to obtain new financing, and to maintain existing financing collateralized by securities. The decline in volume of general trading in the securities industry was so precipitous from April 1970 to June 1970 that emergency relief (implemented by the Exchange, but approved by the Commission) was required in the form of a $15 surcharge placed upon each securities transaction. This decline in volume adversely affected Peck's [19; 1190] profit projections for Dempsey, and his converse proposition was borne out as Dempsey's operating losses continued. This precipitous failure in the securities market, particularly in the King stock, and the recession in securities trading were not anticipated on the date of Hughes' subordination. Hughes acknowledged the unforeseeability of these dramatic events to be a simple truth. Another unforeseeable factor was King's failure to shore up his stock held in escrow to secure his $7 million note. Under the King loan agreement, he was required to add whatever additional security was necessary in order to maintain the value of the stock. King did not perform its obligation, and the capital value of his loan declined as a direct consequence of the decline in value of his stock.

In the first week of June 1970, the Exchange determined that Dempsey might not be able to meet its pro-

[24]"Agreement Subordinating Individual's Account," between Hughes and Whitney, dated March 24, 1970. Exhibit 15.

[25]"Subordination Agreement," between Hughes and various officers acting on behalf of Dempsey, dated January 20, 1970. Exhibit 11.

[26]Letter from Hughes to the Exchange's Department of Member Firms—Division of Finance, undated. Exhibit 12.

[27]"Financial Supplement to Application of Reuben P. Hughes [d]ated March 24, 1970 Concerning the Member Corporation, Dempsey-Tegeler & Company, Inc.," signed by Hughes and Whitney, undated. *See* Exhibit J.

[28]SEC "Unsafe Study," *supra*, at 72.

jections, and that its customers might require recourse to the trust fund. On June 4, 1970, the trustees authorized $5 million from the trust fund to be placed on standby. Liquidation of Dempsey became an immediate possibility. On or about July 15, 1970, Hughes' subordinated securities were sold as provided for in the subordination agreement. On August 7, 1970, Dempsey's liquidation was commenced by the execution of a liquidation agreement by Dempsey's voting stockholders and the Exchange, which provided for the appointment of a liquidator. The trust fund expended $22.6 million to Dempsey's customers. At the time of this case's initial submission, the liquidation had recovered $1.7 million, with contemporary, maximum prospects for recovery set at $13 million above the $1.7 million figure. Of the approximately $36 million negative net worth set for Dempsey as of the liquidation audit on August 20, 1970, the liquidator had recovered $15 million through accounting research, which has been used to the benefit of Dempsey's creditors. The $15 million recovered by the liquidator plus the $1.7 million recovered by the trustees reduced the actual negative net worth of Dempsey upon liquidation as of August 20, 1970 to $19.3 million. Continued recoveries up to the maximum amount of $13 million may eventually reduce the ultimate negative net worth of Dempsey to $6.3 million. [20; 1191] Hughes lost $1,271,600.00 in his subordination to Dempsey. He maintained an account with a member firm, dealing through Walraven as his registered representative, and through Whitney as the supervisor of his account at that firm, until April 1971, on the eve of this lawsuit.

Statement of the Issues.

The issues in this case are quite complex and do not lend themselves to simple statement or to independent formulation. However, five very broad questions can be phrased at this juncture, which allow for some frame of reference for the following discussion and analysis.

I. Whether the inherent nature of Hughes' subordination entitles it to protection under the two Federal securities statutes.

II. Whether the Exchange was obligated toward Hughes under Federal law, and if so, what was the nature, extent, and consequences of nonperformance of that obligation.

III. Whether the Commission's role affected the nature, performance, and consequences of any obligation to be performed by the Exchange for Hughes.

IV. Whether the nature of the subordination agreement, and of Hughes' status and role vis-a-vis the Exchange and Dempsey, allowed recovery by Hughes against the Exchange, Dempsey and Whitney.

V. Whether any basis lies for Hughes' recovery premised on the August 1970 liquidation agreement executed between the Exchange and Dempsey.

These issues do not necessarily signal order of discussion, or of priority in treatment. Equally important subissues implicitly raised by the very statement of these five primary issues may appear to be more dispositive in the final analysis. There will be no at-

tempt to segregate discussion of the primary issues or subissues, indeed, the dovetailing of the issues of law is inevitable. [21; 1192]

Discussion of Law.

The threshold question challenges the viability of Hughes' statement of claims inasmuch as it pertains to the effect of the subordination agreement under the securities laws. An analysis begins with two basic premises: (1) Hughes negotiated and purchased a subordination agreement with Dempsey which would subject his securities to the claims of actual and potential creditors in exchange for standing interest on the securities, plus an additional interest rate which was also provided by the agreement; and (2) the Federal securities laws were designed for the purpose of avoiding frauds, and to this end they should not be construed restrictively nor technically, but flexibly to effectuate their remedial purposes. *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

The latter premise is to be applied to the very definition of a "security" within the two statutes. *See* section 2(1), Securities Act, 15 U.S.C. 77(b)(1), and section 3(a)(10), Securities Exchange Act, 15 U.S.C. 78(c)(10). Particularly, these definitions should embody flexible rather than static ideas, which are capable of matching the various schemes devised by those who seek the application of others' property for the promise of profit, *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946), and should look to substance, not form, with emphasis on the economic realities of the transaction or device. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The term "security" is defined within sections 2(1) and 3(a)(10) as including "any

. . . investment contract." An "investment contract" within the Securities Act is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *S.E.C. v. W. J. Howey Co., supra* at 298-299. The facts clearly indicate that Hughes contemplated acquisition of profits from his investment of securities, pursuant to the subordination agreement, which investment was controlled solely by the efforts of those who promoted the idea to him. Therefore, the subordination agreement was an "investment contract" under the Securities Act, and is entitled to protection as "security." [22; 1193] Inasmuch as the subordination agreement does not fall within the short-term commercial paper exemption provided for in section 3(a)(1), it is to be considered an "investment contract" under the Securities Exchange Act, and is also entitled to protection as a "security" under that statute. *See Sanders v. John Nuveen & Co., Inc.*, 463 F. 2d 1075, 1078-1079 (7th Cir., 1972). Furthermore, inasmuch as the subordination agreement, on its face, establishes an obligation to pay an amount of money earned as interest for the use and application of securities, it is deemed to be an "evidence of indebtedness" within sections 2(1) and 3(a)(10). *See United States v. Jones*, 450 F. 2d 523, 525 (5th Cir., 1971); *Farrell v. United States*, 321 F. 2d 409, 417 (9th Cir., 1963); *cert. denied*, 375 U.S. 992 (1964). Finally, inasmuch as the subordination agreement created an obligation for Hughes to transfer or otherwise dispose of certain interests in his securities in exchange for value, it is deemed to have constituted a "sale" of securities within section 2(3) of the Se-

curities Act, 15 U.S.C. 77b(3) and within sections 3(a)(14) and 3(a)(10) of the Securities Exchange Act, 15 U.S.C. 78c(14) and (10). *See S.E.C. v. National Bankers Life Insurance Co.*, 334 F. Supp. 444, 456 (N.D. Texas, 1971). Accordingly, the subordination agreement is entitled to protective coverage by the two Federal statutes.

The next three broad questions cannot, as a practical matter, be compartmentalized. However, they do suggest an approximate order of treatment. The first question must concern the source of the Exchange's powers to regulate member firms, and the nature of such powers, i.e. what is the meaning to be attributed to the Exchange's "discretionary powers" under the Securities Exchange Act. Section 6 of this statute provides for the registration with the Commission of any exchange as a "national securities exchange" "under the terms and conditions" therein provided. *See* 15 U.S.C. 78f(a). The import of section 6 is clear on its face. Broad powers are indeed granted to such "national securities exchanges," but their ultimate *direction* and *purpose* are not subject to academic dispute—such institutions are to "enforce so far as is within [23; 1194] [their] powers" compliance by their member firms with the provisions of Chapter 3B—Securities Exchanges. 15 U.S.C. 78f(a)(1). Since Congress provided for the delegation of such authority to the exchanges, the latter have the clear responsibility to pursue that charge. A section 6 registration agreement is subject to an apparent condition subsequent that it shall not remain in force unless the exchange's rules provide for the "expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade," and unless the exchange's rules *declare* that the "willful violation" of any provisions of said chapter "shall" be considered conduct inconsistent with just and equitable principles of trade. 15 U.S.C. 78f(b). Thus, the "discretionary" charge foresees *mandatory* action under certain conditions. Accordingly, it cannot be deemed that the Exchange has been given unrestrained, discretionary authority to regulate member firms—rather its charge was to comply *in all respects* with the provisions of Chapter 2B in relation to its control over member firms. This was expressly provided for in a separate subsection where Congress saw fit to allow exchanges to fashion and adopt new rules implement the purposes of Chapter 2B. 15 U.S.C. 78f(c). Such "rules" as the exchanges promulgated included constitutional provisions within the scheme of section 6— "whatever the name" given to such self-regulatory guidelines. 15 U.S.C. 78f(a)(3).

Thus, the assertion that the Exchange's regulation of member firms is essentially a "discretionary" function is shallow once the statutory charge is closely examined. This is consistent with the purpose and scope of the Securities Exchange Act. The impotency of a private-club atmosphere, with its attendant tendencies to eschew self-regulation, became inapposite to the demands and risks of a national economic and financial system. *Silver v. New York Stock Exchange*, 373 U.S. 341, 351 (1963). Congress' intent in providing the enforcement scheme in this statute was to supply a protective shield in place of the " 'enlightened self-interest in private leadership' " which, as a result of " 'inertia, pressure of vested interests, lack of organization, or otherwise,' " had [24; 1195] not been able to provide the methods of protection to match the challenges of

rapid change and growth in business. *Silver, supra* (citing H.R. Rep. No. 1383, 73d Cong., 2d Sess. 15 (1934) at 3). In support of its argument that section 6 leaves "broad discretion" to the exchanges in interpreting and applying their own rules, the Exchange cites *Intercontinental Industries, Inc. v. American Stock Exchange,* 452 F. 2d 935, 940 (5th Cir., 1971). The Fifth Circuit did refer to such discretion, but in the context of upholding the American Stock Exchange's discretion in the application of one of its own rules, which application was previously approved by the Commission. *Id.* Two crucial facts distinguish the instant case: (1) Hughes is suing for the Exchange's *failure* to apply its rules; and (2) the Commission took no formal action whatsoever, indeed there is a *suggestion* that the Commission did not perform its duty, under section 19(b), to order changes in exchange rules in appropriate situations. *See* discussion, *infra*. The defendant's exposition of the Commission's posture toward the imposition of penalties against Dempsey by the Exchange, and its suggested conclusion that, if the Exchange had been remiss the Commission could have taken action, begs the question whether a private cause of action remains notwithstanding any executive response on the part of the Commission, or in the *absence* of any such response. The cases indicate that a private right of action does lie against the Exchange for an alleged violation of its duties established by Congress under section 6. *Baird v. Franklin,* 141 F. 2d 238, 244-245 (2nd Cir., 1944); *cert. denied,* 323 U.S. 737 (dissenting opinion) (majority held damages not *caused* by breach of duty); *Bright v. Philadelphia Baltimore-Washington Stock Exchange,* 327 F. Supp 495, 500-503 (E.D. Pa., 1971) (duty to abide by rules in insuring fairness in annual

elections; *Weinberger v. New York Stock Exchange,* 335 F. Supp. 139, 142 (S.D.N.Y., 1971) (duty to plaintiff on third party beneficiary theory created cause of action not barred by statute of limitations); *see also Butterman v. Walston & Co.,* 387 F. 2d 822, 825 (7th Cir., 1967); *rehear. denied en banc* (1968); *Pettit v. American Stock Exchange,* 217 F. Supp 21, 29 (S.D.N.Y., 1963). [25; 1196] Accordingly, Hughes did have a private right of action against the Exchange for an alleged violation of its section 6 duties toward Dempsey under the Securities Exchange Act. The measure of this duty as applied to the facts of this case, i.e. whether the Exchange abused its discretion, or otherwise violated its statutory charge, depends to a certain extent upon Hughes' status, and, to a greater extent, upon the nature and amount of information to which Hughes had access—or to which he should have had access. These are questions which must be reserved for a simultaneous treatment of Hughes' relationship with the other principal characters, and of the evolution of the subordination agreement. *See* discussion, *infra.* However, other preliminary questions as to the status of the Exchange have been posed.

Hughes contends that the Exchange was a "controlling person" under the securities acts, and that its relationship with him was that of a fiduciary. The liability of a "controlling person" under these acts is governed by section 15 of the Securities Act, 15 U.S.C. 77o, and by section 20(a) of the Securities Exchange Act, 15 U.S.C. 78t(a). In essence, these sections provide for the joint and several liability of any person who, directly or indirectly "controls" any other person who is subject to liability under sections 11 and 12 of the Securities Act, 15 U.S.C. 77k and 77L, and

under Chapter 2B of the Securities Exchange Act, *unless* such "controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist," under the Securities Act, or *unless* such "controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action" under the Securities Exchange Act.

The reach of potential liability under sections 15 and 20(a) is very broad. (At this juncture, the distinction between the dispositive language in the two sections pertaining to "knowledge," "belief," and "good faith" is deemed to be insignificant for purposes of determining whether the Exchange was a "controlling person" under these sections. Liability will be raised [26; 1197] subsequently. *See* discussion, *infra.*) Section 15 was not intended to serve as a *limitation* on liability of persons extending control over others, rather it was intended to supplement and extend beyond the common law principles of agency and *respondeat superior. Johns Hopkins University v. Hutton,* 297 F. Supp 1165, 1211-1213 (D. Md., 1968); *rev'd on other grounds,* 422 F. 2d 1124 (4th Cir., 1970). Similarly, section 20(a) has been given equally broad treatment, which is consistent with the liberal rules of construction afforded the Securities Exchange Act to enable that statute to achieve its remedial purpose. *S.E.C. v. First Securities Co. of Chicago,* 463 F. 2d 981, 986-987 (7th Cir., 1972); *rehear. denied* (1972); *cert. denied.,* 93 S. Ct. 85 (1972). Section 20(a) "has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." *Myzel v. Fields,* 386 F.

2d 718, 738 (8th Cir., 1967); *cert. denied,* 390 U.S. 951 (1968); *Strong v. France,* 474 F. 2d 747, 752 (9th Cir., 1973). Clearly, in light of the plain language of sections 15 and 20(a) and the cases cited, the Exchange was a "controlling person" under these two statutes. Indeed, to hold otherwise would be anomalous. One of the Exchange's prime defenses is that it fully and satisfactorily exercised its "discretionary" powers under section 6 with respect to the handling and management of Dempsey during the critical period. The Exchange directed Dempsey to make personnel changes, close offices, reduce operations, and to centralize accounting procedures, in addition to suspending its own requirements pertaining to Dempsey's capital position and accounting practices. *See* discussion, *supra* and note 23. Accordingly, the Court finds the Exchange to be a "controlling person" of Dempsey during the relevant period within the meaning of sections 15 and 20(a). A fortiori, the Exchange must be deemed to have been a fiduciary vis-a-vis Hughes under these circumstances, and must be considered to have been under all obligations attendant to that position. *Baird, supra* at 246-247. Finally, with respect to the question whether the Exchange was an aider and abettor of the alleged fraudulent conduct engaged in by Dempsey, Whitney or [27; 1198] Walraven, two general requirements must be satisfied: (1) knowledge that there was a breach of duty; and (2) substantial contribution or encouragement to the person committing the breach. See *Brennan v. Midwestern United Life Insurance Company,* 286 F. Supp 702, 708-709 and 725 (N.D. Ind., 1968), *aff'd.* 417 F. 2d 147, 154-155 (7th Cir., 1969): *cert. denied,* 397 U.S. 989 (1970); *Pettit v. American Stock Exchange, supra*

at 28. 217 F. Supp 21, 28 (S.D.N.Y., 1963). However, both of these requirements raise duty, breach and causation elements which must be dealt with subsequently. *See* discussion, *infra.*

Before applying the conclusions above to the facts and remaining questions of law, a focus upon the Commission and its role in this case is appropriate at this time. The question might be phrased as follows: whether the Commission abstained from implementing statutory sanctions against the Exchange, basing its response upon the information supplied by the Exchange as to the condition of Dempsey, and, if such a posture was in fact assumed by the Commission, what significance is to be attached to such regulatory abstention. This, of course, raises very crucial questions, including: (1) whether the Commission did abstain from moving against the Exchange; (2) whether the Commission had full and complete information as to the condition of Dempsey so as to credit an appropriate weight to its response; and (3) whether any action or inaction of the Commission, nevertheless, is moot insofar as an injured party may be entitled to a private right of action against the Exchange.

The facts indicate that the Commission did not take "formal" action against the Exchange pursuant to its statutory mandate under section 19(b), 15 U.S.C. 78s(b). *See* discussion, *supra.* Section 19(b) authorizes the Commission to request exchanges to implement specified changes in their rules and practices, and, if such changes are not thus implemented, it authorizes the Commission to alter or supplement such rules and practices by rules or regulations "appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange." The facts [28; 1199] indicate that the Commission endeavored to create an *informal* information-gathering relationship with the Exchange on the state of its member firms, particularly Dempsey, and that the Commission sought to make its presence felt as an intensely interested official body. However, the facts are also very clear that the Commission's options under the Securities Exchange Act were, for all intents and purposes, precluded by two paramount factors in this case: (1) the Exchange's essentially exclusive control over, and access to, the barometers by which the financial and accounting state of the member firms could be determined, in particular, the capital and accounting records of Dempsey; and (2) the Exchange's singularly dispositive, unilateral decision, entirely within its discretionary powers, to withhold the availability of its trust funds from creditors should the Commission impose receivership upon Dempsey. The former simply made the Commission wholly dependent upon the Exchange as a source of necessary information as to Dempsey. The latter simply made relative inaction on the part of the Commission mandatory if it sought to maintain stability within the industry as a whole. Thus, these two paramount factors, in effect, relegated the Commission's stature in this instance to that of, essentially, an advisory board. Accordingly, not only did the Commission abstain in this case, but the Court certainly cannot conclude that it had that measure of available information which would then render such inaction on its part as an indication of either tacit administrative approval, or unequivocal administrative sanctioning of the Exchange's efforts vis-a-vis the Dempsey question.

Both parties cite *Silver, supra* and *Ricci v. Chicago Mercantile Exchange*, 409 U.S. 289 (1973) in support of their respective positions. *Silver* recognized that the Commission had power under the Securities Exchange Act to request rule changes of the exchanges, and to disapprove of any adopted rules. 373 U.S. at 357. However, the Supreme Court noted that the Act "does not give the Commission jurisdiction to review particular instances of enforcement of exchange rules," and therefore the question of administrative exhaustion before the Commission was [29; 1200] precluded. *Id.* The Supreme Court limited the issue to the extent to which the character and objectives of the duty of exchange self-regulation contemplated by the Securities Exchange Act are incompatible with the maintenance of an antitrust action." 373 U.S. at 358. Immediately thereafter, the Court concluded that the mere absence of Commission jurisdiction contributed to the solution of the problem—there was nothing built into the regulatory scheme which would perform the antitrust function of insuring noninjury to competitors by the application of exchange rules. *Id.* By way of analogy, the issue here is only that of the extent to which the character and objectives of the duty of exchange self-regulation contemplated by the Act are incompatible with the maintenance of a securities fraud action, which action directly raises matters involving the "safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility." *See* section 19(b), 15 U.S.C. 7s8(b). Inasmuch as *Silver* represents a holding that the Exchange's duties of self-regulation under the Act are not incompatible with the maintenance of an antitrust action, it follows in analogous fashion, that such duties of self-

regulation as are practiced by the Exchange, and as are subject to interpretation, alteration or revocation by the Commission, nevertheless are not incompatible with the maintenance of this securities fraud action. *See Ricci, supra,* at 301-302. Accordingly, in response to the third, and final, question posed, it appears that, notwithstanding the Commission's response in this case, Hughes was entitled to a private right of action against the Exchange for its application and interpretation of its rules. This would appear to be particularly important in an instance such as this where the Government not only "[k]ept the shotgun, so to speak, behind the door," but, apparently, removed its firing pin, and placed the weapon in a display case. *See Silver, supra* at 352.

The most crucial area of inquiry is now reached. What was the nature of Hughes' status vis-a-vis Dempsey, Whitney and the Exchange as determined both by oral representations and written communications, [30; 1201] including the very source of the controversy —the documents comprising the subordination agreement.

A discussion of the unresolved elements of the principal causes of action under section 12(2) of the Securities Act and section 10(b) of the Securities Exchange Act would be appropriate at the outset. (The two sections' interstate commerce communication and instrumentality requirements, respectively, are clearly satisfied by the facts.) The section 12(2) elements in controversy in this case are as follows: (1) a communication of an untrue statement of a material fact, or of a statement which omits to provide a material fact necessary in order to make that statement, in light of the circumstances under which it is made, not misleading; (2) which arises in the course of an offer or

sale of a security; (3) which was made without Hughes' knowledge of such untruth or omission; and (4) which was made with the knowledge of the offeror, or, in the exercise of reasonable care, could have been made with his knowledge. *See Johns Hopkins University, supra,* 422 F.2d at 1128. The elements at issue for a section 10(b) recovery in this case are less restrictive; (1) the use or employment of any manipulative or deceptive device which incorporates a communication of a "material misstatement of an omission of a material fact;" and (2) which communication was made "in connection with the purchase or sale of any security." *See Royal Air Properties, Inc. v. Smith,* 312 F. 2d 210, 212 (9th Cir., 1962); *Ellis v. Carter,* 291 F. 2d 270, 274 (9th Cir., 1961); *Matheson v. Armbrust,* 284 F. 2d 670, 673 (9th Cir., 1960).

In addition, certain other burdens and privileges obtain under these sections' causes of action. Although the purchase language of section 12(2) would seem to clearly embrace the concept, privity of contract does not seem to be required for the maintenance of a section10(b) cause of action, *see Texas Continental Life Insurance Company v. Dunne,* 307 F.2d 242, 249 (6th Cir., 1962); *rehear. denied* (1962), indeed, it may have all but disappeared as a prerequisite. *See* 2 Bromberg, *Securities Law: Fraud* §8.5 (511) and cases cited. In order to prevail under a section 12(2) claim, Hughes is neither required to demonstrate scienter, or intent [31; 1202] to defraud, on the part of the defendants, *Phillips v. Alabama Credit Corporation,* 403 F. 2d 692 (5th Cir., 1968); *Woodward v. Wright,* 266 F. 2d 108, 116 (10th Cir., 1959); *rehear. denied* (1959), nor is he required to prove reliance. *Woodward, supra; John Hopkins University, supra,* 422 F.

2d at 1129. Hughes does not need to prove scienter to prevail in a section 10(b) cause of action. *Hecht v. Harris, Upham & Co.* 430 F. 2d 1202, 1209 (9th Cir., 1970); *mod'f on denial of rehearing* (1970). And, under circumstances involving primarily a failure to disclose, circumstances found to exist in the instant case, Hughes need not submit "positive proof of reliance" to recover under section 10(b) and the Commission's Rule 10b-5 promulgated thereunder. *Affiliated Ute Citizens of Utah v. United States,* 406 U.S. 128, 152-153 (1972); *see* 2 *Bromberg, supra* at §8.6(2). Causation-in-fact between the subject representations and Hughes' loss apparently may be presumed, as a matter of law under a section 12(2) cause of action, if the representations conveyed which surrounded the consummation of the subordination agreement were, in fact, false or misleading. *Johns Hopkins University, supra,* 422 F. 2d at 1129-1130. Causation-in-fact as a requisite element for a successful section 10(b) cause of action similarly may be presumed to exist where the element of materiality is present in connection with the purchase of the subordination agreement, either as to the communication of a statement which fails to provide certain facts or as to the communication of a misrepresentation. *See* 2 Bromberg, *supra* at §8.7(2).

An appropriate test for materiality under section 12 (2) is whether a fact concerns information about which " 'an average prudent investor ought reasonably to be informed before purchasing the security,' " *Johns Hopkins University, supra,* 422 F. 2d at 1128, or whether its " 'existence or nonexistence is a matter to which a reasonable man would attach importance in determining his choice of action in the transaction in question.' " *Id.* at 1129; *see* 3 Loss, *Securities Regula-*

tion, 1431 2d ed (1961). Essentially the same test for materiality is applied under section 10(b), for example, whether it would have been reasonable for a person to [1203] have been influenced differently if a communicant had not misrepresented or withheld a particular fact. *See List v. Fashion Park, Inc.* 340 F. 2d 457, 463 (2nd Cir., 1965).

With respect to Hughes' personal status, any measure of his investment sophistication is deemed to be an irrelevant criterion under a section 12(2) claim, *Johns Hopkins University, supra,* 297 F. Supp. at 1217. This Court has previously noted that Hughes was gifted with an uncommon ability to nurture and manage business enterprises, however, he was neither principally an investor of stocks, nor was he a trained and experienced accountant, knowledgeable in the finer details of data interpretation. In any event, even if this Court were to conclude otherwise, that Hughes' status lay beyond the definition of an "ordinary" investor, this would seem to be an irrelevant criterion as well for a section 10(b) claim. Some circuits have pointedly imposed the requirements of a relatively stringent duty of continuously maintained diligence upon "sophisticated" investors. *Heit v. Weitzen,* 402 F. 2d 909, 913 (2nd Cir., 1968); *cert. denied* 395 U.S. 903 (1969); *City National Bank of Fort Smith, Ark v. Vanderboom,* 422 F. 2d 221, 230 (8th Cir., 1970); *cert denied,* 399 U.S. 905 (1970); *Clement A. Evans & Co. v. McAlpine,* 434 F. 2d 100, 103 (5th Cir., 1970); *rehear. denied* (1970). The Ninth Circuit, emphasizing particularly demonstrated facts applied in light of general principles, has not fashioned a set formula. Rather it appears to emphasize that measure of knowledge, however acquired through discovery (whether

by means of self-initiative, or inadvertent or intentional enlightenment provided by others) which would satisfy the element of "knowledge" as it may be applied, respectively, within the available defenses of waiver, estoppel or laches, and which, if relevant and appropriate, would appear to afford a particular defendant the usage and successful application of such defenses in countering a section 10(b) cause of action. This measure of knowledge on the part of a plaintiff ranges from that which may be obtained through the *exercise of reasonable diligence* in the discovery of one's rights in a given situation, which rights may be subsequently impaired as a result of the transaction in [33; 1204] question (generally, instances involving the defenses of estoppel and laches) to that which can only be obtained by *full and complete discovery,* and which can only be demonstratively established by a showing that the party acted with actual knowledge as to the impairment of said rights (generally, an instance involving the defense of waiver.) *See Royal Air Properties, Inc. v. Smith,* 333 F. 2d 568, 572 (9th Cir., 1964); *Hecht, supra,* at 1207-1208. It appears, thus, that the Ninth Circuit places no special distinction upon a particular person's *past status or experience,* i.e. whether he should be deemed to be a "sophisticate" or a "novice" in securities investment, since the former label still raises the ultimate issues of quantity, quality, and sequence of the information acquired. Thus, the test appears to emphasize the *nature of knowledge* acquired by an individual as it may be applied in a particular instance with respect to that same individual, against whom such defenses may be utilized by a defending party at a given point in time.

Having established a framework of principles, the body of fact found in this case may now be applied to determine the obligations of the parties. The following is a synopsis of the more pertinent facts found previously on the instant issue. The Haskins & Sells audit of June 1, 1969, released on September 18, 1969, revealed that Dempsey was in very serious financial trouble, and was experiencing unascertainable accounting difficulties. *See* discussion, *supra* at 6, 8-9. For example, its unresolved "short stock record differences," exclusive of subordinated borrowings, were 213.46 percent of its stated net worth, the worst in the industry. These conditions placed Dempsey perilously close to "insolvency." *See* discussion, *infra*. In August 1959, the Exchange independently arrived at the same conclusions as a result of an analysis conducted by its own examiners. These findings were available to Hughes, and Hughes, as a matter of fact, admitted that they signaled significant discrepancies. Although Hughes himself probably did not fully comprehend the meaning of this data, he had the advice of his business lawyer at all relevant times. In addition, he had access to subsequent, more current [34; 1205] data, and the pointed admonitions offered by Peck on the eve of his subordination. *See* discussion *infra; see also* discussion, *supra* at 16 and note 16 *supra*.

Notwithstanding the knowledge that Dempsey was in violation of its capital and record-keeping rules, the Exchange, for reasons critiqued in depth previously, decided to try to "save" Dempsey. In the course of this action, the Exchange made questionable assumptions, but such assumptions were made in what this Court feels to be essentially characterized as a good faith effort to do principally two things: (1) rescue

Dempsey, and thereby protect its creditors; and (2) prevent a general market loss of confidence, and thereby protect other firms within its responsibility. To this end, the King and Hughes subordinations were solicited, encouraged and ultimately consummated. King provided his own background investigation, and eventually sought certifications from the Exchange prior to his subordination which the latter unequivocally rejected as unacceptable conditions. Nevertheless, King went ahead with his subordination. The King subordination was a major and constant factor influencing Hughes, and was definitely neither insignificant nor remote in causing Hughes to proceed with his own subordination. On the general topic of "influence," a term of broader connotations than causation, more should be mentioned. It appears that six general factors "influenced" Hughes' ultimate decision to proceed with his own subordination, although clearly Hughes did not assign equal weight to them in arriving at this conclusion:

> (1) *the King subordination*—which was based upon an independent investigation, totally apart from the Exchange's control, the results and authenticity of which Hughes did not avail himself, although opportunities to do so timely presented themselves;
>
> (2) *the representations of Walraven and Whitney*—which, because they originated from old trusted friends, were assigned inordinate weight, notwithstanding their emphasis on generalities and patent absence of specific analysis on hard data; [35; 1206]
>
> (3) *the representations of Peck*—which, because they originated from an unknown technician, were

assigned relatively lesser weight by Hughes in the final analysis, notwithstanding this man's credentials and sobering analysis of Dempsey;

(4) *the conclusions of Hughes' own prior investigation*—which, generally, were necessarily limited to current impressions or hard data received directly from Dempsey, and indirectly from the Exchange, as to the viability of the proposed subordination, but which were based also upon only a general knowledge of King's investigation, and, in part, upon past audits of Dempsey;

(5) *the contemporary general market conditions* —which, on the eve of subordination, certainly did not betray harbingers of the subsequent general market deterioration which substantially contributed to the overall weakening of Dempsey almost immediately after Hughes' subordination; and,

(6) *the knowledge of the Commission's apparent acquiescence* in the face of the Exchange's quasi-arrogation of total influence over the Dempsey matter—which, indirectly at least, lent an *appearance* of "official" sanctioning of Dempsey's solicitation of subordinated capital.

Of these six contributing factors, the King subordination and the representations of Walraven and Whitney were given exceptional weight by Hughes in arriving at the decision to proceed with his subordination. Based upon the record in this case, it is not unreasonable to conclude that Hughes assigned a greater proportionate weight to these two factors than to the remaining four in combination with each other. The conclusion is also warranted by the record, although per-

haps it is less easier to infer, that Hughes assigned the least significant weight to the representations of Peck. Perhaps, this was so because the Peck factor provided the most recent and complex data for Hughes, personally, to grasp and comprehend, and [36; 1207] because it was the one particular *individual* with whom he was least familiar. This was most unfortunate, for the Peck factor represented two dispositive facets of information: (1) the *most detailed and current assessment* of Dempsey on the eve of Hughes' subordination; and (2) the (most professional conservative projection *personally offered* to Hughes as to the viability of the entire subordination scheme. Hughes lightly dismissed Peck's representations—in *causal effect,* the "influence" of the Peck factor was relatively remote and insignificant.

At this juncture, it is appropriate to return to the decisive question posed earlier as to the paramount duty existing under section 6: whether the Exchange abused its discretion in applying its "rules," either regulatory guidelines or constitutional provisions, or otherwise breached its statutory duty toward Dempsey under the Securities Exchange Act, so as to be found liable for Hughes' losses suffered as a result of his subordination. The one case most instructive on this crucial point, *Baird, supra,* is distinguishable in two important particulars: (1) the Exchange's role vis-a-vis Richard Whitney's defalcations and stock mismanagement was apparently one of relatively total inaction under its statutory duty, for which it was strongly criticized, 141 F. 2d at 242-246 (dissenting opinion; and (2) the Commission's role vis-a-vis the misconduct of this particular member of the Exchange was virtually nonexistent. (Of course, the latter was primarily due to the surreptitious nature of Whitney's activities,

but, nevertheless, the nature of the "concealment" allegations in this case certainly must be viewed in light of at least an "attempt" by the Exchange to inform the Commission as to what was happening to Dempsey, and what the Exchange intended to do about that member firm's difficulties. Accordingly, these distinctions should be emphasized for very important, even though limited, reasons: (1) the Exchange in this case engaged in a carefully measured response with respect to the member firm, Dempsey, which *did* involve the invocation of *some* internal disciplinary action prior to the introduction of the claimant, Hughes, upon the scene; and (2) the Exchange did make some *attempt* to inform the Commission and all subsequently interested persons, including King and Hughes, of the past [37; 1208] status and current condition of Dempsey (irrespective of the attempt's final effect.) The latter is deemed to be very important because it is in marked contrast to the blatant suppression of the Whitney scandal by the Exchange until extrinsic rumors floated the discovery of the details in January 1938: *Baird, supra,* at 241. These two distinctions pertain most directly and intimately to the question whether the Exchange fulfilled its section 6 duty.

Hughes seeks recovery against the Exchange under several theories of breach of duty for basically two broad, but separable instances of conduct: (1) the carefully modulated imposition of restrictions against Dempsey, and the simultaneous failure to suspend Dempsey under Articles XIII and XIV of the Exchange Constitution; and (2) the encouragement and approval of the subordination agreement between Hughes and Dempsey. Generally, the five broad theories of recovery, which overlap to a great extent, are:

(1) the duty under section 6 of the Securities Exchange Act; (2) the duty under section 10(b) of the Securities Exchange Act, which, for purposes of this case, extends substantially beyond the fraudulent sale duty contemplated within section 12(2) of the Securities Act, and encompasses the related, potential liabilities contained within section 17 of the Securities Act, 15 U.S.C. 77q; (3) the duty of a "controlling person" under the two Federal securities laws; (4) the general duty of a fiduciary at common law (which, Hughes seeks to emphasize by analogizing the Exchange as an "insider" within section 16 of the Securities Exchange Act, 15 U.S.C. 78p); and (5) the general duty under tort law, the breach of which makes one an aider and abettor to a principal tortfeasor at common law.

Because of its sweep, and the continuing nature of its obligation, the section 6 duty is intimately linked with the two broad instances of conduct described above. It may be phrased more precisely now as follows: whether the Exchange satisfactorily performed its obligation under section 6 to take disciplinary action against Dempsey, either through imposition of *increased* restrictions or through invocation of *final* suspension proceedings, in light of facts and conditions it knew, or should have known, [38; 1209] pertaining to Dempsey's financial and accounting condition up to and including March 24, 1970, the date of Hughes' entry into subordination.

The following are the dispositive conclusions of fact and law which provide the resolution to that question concerning the section 6 duty of the Exchange:

(1) the Exchange initially became aware of Dempsey's difficulties in 1964-1965, and, during that

period, it *ordered compliance* by Dempsey with the Exchange's capital and record-keeping rules;

(2) the Exchange *subsequently restricted* Dempsey's business, including the limiting of weekly trades, and the requiring of an infusion of new capital, which eventually came from the Dempsey partnership;

(3) the Exchange *sanctioned Dempsey's management*, which eventually resulted in the installation of new leadership under Whitney;

(4) the Exchange sought to accommodate the interests and concerns of the Commission, the regulatory body ultimately responsible for the conduct of Dempsey, and attempted to cooperate as much as possible with that agency by keeping it apprised of developments (however, too often this effort was compromised and curbed by factors beyond the control of both the Exchange and the Commission, including imponderable economic forces);

(5) the Exchange solicited subordinated capital to shore up Dempsey, *but only under certain conditions* which were carefully and clearly communicated to the two proposed subordinators, King and Hughes, and which included a *substantial unknown factor* of incalculable weight in affecting the eventual outcome of the subordination solution;

(6) the Exchange subsequently determined that Dempsey was facing increasingly serious difficulty, but that the planned [39; 1210] subordinations still *might* solve Dempsey's problems, hence the Exchange determined not to suspend Dempsey, or to so restrict its business as to amount to

a termination of Exchange support and backing *—such determination was highly presumptuous yet still implemented in good faith;*

(7) the Exchange viewed the proposed subordination by Hughes as a *partial remedy* for Dempsey, which view was essentially in accord with that of Peck (who had been hired by Dempsey under the reorganization efforts instigated by the Exchange, and who had also communicated in reasonably complete and coherent terms to Hughes at the final conference prior to subordination, and which was supported by documentation available for Hughes' personal, professional assessment for a sufficient period of time prior to his entry into subordination;

(8) the Exchange concluded that the *nature and extent of the risk* in the Hughes subordination scheme was *reasonably apparent* to Hughes, and assumed that he was fully aware that Dempsey's recovery was premised on *contingent factors*, other than the mere infusion of a stated amount of capital, which factors were beyond the prediction and control of the Exchange, and thus beyond its duty to disclose;

(9) the Exchange's conclusions and assumptions, including its *doubt* about Dempsey's recovery, were patently described to Hughes by Peck, which description raised not only the hard "known" data at the time, but the presence of the "unknowns" which had to be accounted for; and

(10) the Exchange did not foresee, could not have foreseen, *nor should it have been required to foresee*, the subsequent surprise factor that

market conditions would undergo a dramatic, rapid and sharp decline almost immediately after the Hughes' subordination entered into force—these market conditions were [40; 1211] decisively fatal to the reorganization plan Peck explained to Hughes on the eve of subordination.

Based upon an overall assessment of the above dispositive conclusions, it cannot be determined that, under the specific circumstances of Hughes' subordination of his securities, the Exchange breached its section 6 duty toward Hughes, in light of the facts of which it had knowledge, or reasonably could have acquired, by the time of his subordination, and in light of the prior and contemporaneous conduct practiced and measures taken during the relevant period from the time the Exchange first became aware of Dempsey's deficiencies to the time of Hughes' subordination. Although it was controversial, it was not unreasonable for the Exchange to refrain from taking further, perhaps more drastic, measures against Dempsey prior to Hughes' subordination (particularly in light of the two priorities previously determined and implemented within its discretionary powers vis-a-vis member firms, which determination, incidentally, also stemmed from the section 6 obligation, *see* discussion, *supra* at 35. And, although it was momentous, it was not an abuse of discretion, nor a violation of a statutory charge, for the Exchange to affirmatively solicit a subordination with the character, qualifications, and understanding, of that which was eventually consummated with Hughes. A contrary finding under the section 6 theory of recovery would appear to place national securities exchanges in an impossible position of making an ul-

timate choice between two alternative courses of action —either to submit themselves to a form of strict liability for the potential risks inherent in the type of protective scheme devised to preserve Dempsey, or to forego equally important obligations—legal *and* ethical—to other members of their national organizations and their clients. Such a choice does not seem to make sense under the Securities Exchange Act for it would at once remove fundamental flexibilities and discretions necessary for the effective functioning of national securities exchanges.[29] Accordingly, the section 6 duty

[29]Congress seemed to be aware of this dilemma thrust upon the national securities exchanges, and, simultaneously, appeared to provide a mechanism by which such future crises could be avoided. In enacting the Securities Investor Protection Act of 1970, 15 U.S.C. 78aaa *et seq.*, Congress provided a statutory scheme by which such crises could be anticipated, dealt with, and resolved on a fair and equitable basis. For example, section 5, 15 U.S.C. 78eee, sets up a comprehensive scheme by which customers of member firms may invoke remedies to regulate the firm in difficulty or otherwise gain assistance. Section 5 requires, in mandatory language, that the Commission, or the appropriate "self-regulatory" body [including national security exchanges, *see* 15 U.S.C. 78LLL(1)] notify immediately the Securities Investor Protection Corporation of any member firm in financial difficulty. The Corporation may then apply to a district court for a decree adjudicating the member firm to be in need of protection under the Act, and that court has the power to determine a variety of measures if the customers of the member firm need protection. Section 6 of the Act, 15 U.S.C. 78fff, sets up a mechanism for liquidation proceedings. Section 7(a)-(c), 15 U.S.C. 78ggg, creates a clear duty for the Commission to determine, independently of the Corporation, whether the latter should discharge its responsibilities provided under the Act with respect to any member firm. Section 9(f), 15 U.S.C. 78iii(f) is even more explicit with respect to the new active rule for the Commission envisaged by the Act. This subsection provides that, *notwithstanding* the relatively general duties set forth in section 19 of the Securities Exchange Act, 15 U.S.C. 78s, the Commission is *specifically empowered* to take "specified" measures with respect to the alteration of any self-regulatory organization's rules or regulations, and also allows the Commission to require such organizations to either furnish the Commission with reports and records of the financial condition of members, subsection 9(f)(2), or to inspect

accorded to Hughes under the Securities Exchange Act was not breached by the Exchange. [41; 1212]

Thus disposing of that theory of recovery, the duties of the Exchange under section 10(b), section 12 (2), section 17, and as a "controlling person" under sections 15 and 20(a) can now be examined. Generally, the latter theory, along with the remaining theories of recovery previously mentioned, *see* discussion *supra*, at 38, pertains to the second broad instance of

any member of such organization with respect to its financial condition, subsection 9(f)(3). This subsection clearly gives the Commission formal, express power, beyond its otherwise indirect leverage on self-regulatory organizations' rule making procedures, to take affirmative measures in a direct fashion with respect to those conditions which might eventuate in a Dempsey-type crisis.

Congress does exclude subordinated lenders from the protection of the Act, under section 6, 15 U.S.C. 78fff(c)(2)(A)(ii), however, this exclusion operates *after* liquidation proceedings have commenced, which must be preceded by either Commission or Corporation action to relieve a member from financial crisis. Apparently, the theory is that the regulatory framework would seem to create at least a higher profile of the nature of the risk for subordinated lenders, or less preferred creditors. For example, upon indications of possible capital or accounting problems, the Commission or the Corporation, may institute court proceedings designed to stay any legal action against the member in trouble, to suspend its business affairs, and to place it in receivership with ultimate equitable distribution of assets as the final phase. Accordingly, creditors are prevented from obtaining a preferred judgment status, and general confidence prevails among members of the Corporation and their creditors. Obviously, Hughes did not have the rights and benefits of this mechanism working for him during the relevant period of this case. The Commission, and the self-regulatory body involved, the Exchange, had less clearly defined roles, and individual and mutual responsibilities under the Securities Exchange Act *prior to* the 1970 amendment. There were no checks and balances built into their relationship which would have either incited a different response earlier, or would have altered the responses at different stages of the critical period. Since Hughes' cause of action accrued prior to the entering into force of this Act, and because his subordination solicitation and consummation were not entitled to the protective safeguards built into this statute, therefore it cannot preclude recourse to other remedies available to him under the Securities Exchange Act.

conduct for which the Exchange may be accountable —the encouragement and approval of the subordination agreement. The *status* of the Exchange as a "controlling person" under the two Federal securities acts has been previously ascertained. *See* discussion, *supra* at 26-27. The dispositive question now concerns the *conduct* of the Exchange under that status, to wit: whether the Exchange had knowledge of, or reasonable ground to believe in the existence of the facts by reason of which the liability of Dempsey is alleged to exist, or whether the Exchange acted in good faith and did not directly or indirectly induce the purported representations which constituted the alleged violation under the securities laws. This Court has already determined that, as a whole, the Exchange's conduct in this case was performed in good faith. This is supported by the general manner in which the subordination agreements were solicited and eventually consummated, i.e. with requisite attention to detail, and with particular conditions specified as to the posture of Dempsey within the Exchange's organization before and after the subordination agreement with Hughes entered into force. The other factors pertaining to the Exchange's conduct raise the threshold question whether the conduct of *other persons* created a cause of action for which the Exchange may be deemed liable, if in fact it knew, or there was reasonable ground for it to know, of the factual basis for such liability, or it directly or indirectly induced those acts constituting the basis for such "controlled persons' " liability.

Simultaneously, this line of inquiry raises the opportunity to conduct an examination of the Exchange's potential liability under section 10(b) of the Securities Exchange Act inasmuch as that section raises ques-

tions of a substantially similar nature bearing upon the Exchange's possible employment of *any scheme or device* in contravention of the Act or of [42; 1213] Commission regulations promulgated under Chapter 2B of the Act. Thus, this related inquiry would extend beyond the Exchange's strict relationship vis-a-vis any "controlled person" and its agents, into an area of conduct which resurrects the broad, section 6 affirmative conduct responsibilities and duties in a different context. (The overlapping of these several statutory duties is an inevitable development of this case.) The resolution of the Exchange's potential liabilities under section 15 of the Securities Act, and sections 10(b) and 20(a) of the Securities Exchange Act necessitates an examination at the outset, of those persons directly involved in the communications—oral and written—which pertained to the Dempsey subordination scheme on the dates leading up to and ending in the date of subordination on March 24, 1970.[30]

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[30]Hughes may utilize any of several communications as a basis for which he can demonstrate liability-creating information, or lack of material information, originating from, e.g. official communications between the Commission and the Exchange, between the Commission and Dempsey, and between the Exchange and Dempsey; official or unofficial communications released to the public media; and other communications of varying status allowed to appear in other securities market publications. *See generally* 1 Bromberg, *supra* at §7.6(2)(b). Generally, Hughes relied upon two categories of information upon which he based his decision to subordinate—written documentation and oral representations. It has been previously determined that Hughes relied *principally* upon the representations—oral and written—offered on March 23, 1970 in arriving at his final decision to subordinate. Of the six general factors previously mentioned, *see* discussion, *supra* at 35, Hughes apparently deemphasized most of the Exchange and Commission documentation available to and presented by his own researchers, and the March 23 oral representations and written materials presented by Peck. Accordingly, Hughes' claim of misinformation or omission of mate-

(This footnote is continued on next page)

The principal, individual actors relevant to this point were Walraven, Whitney and Peck, all representatives of Dempsey. Generally, an agent may be defined as one who acts in a fiduciary capacity for and on behalf of another with that other person's consent, and subject to his control to so act. Restatement (Second) of Agency §1 (1958). Walraven, Whitney and Peck were agents of Dempsey under this definition within the relevant time period. Representations made by an agent within the scope of his employment, and with the actual or apparent authority of the principal are binding upon the principal, and he is responsible for such representations. 3 Am.Jr.2d Agency §264 (1962). This Court has previously ascertained that Peck's representations to Hughes on March 23, 1970, viewed as a whole and in the context of their delivery, certainly conveyed the distinct impression that a substantial risk factor existed in the subordination scheme. *See* discussion, *supra* at 17-19 and 40. This assessment by Peck certainly contained minimal information about which " 'an average prudent investor ought reasonably to be informed before purchasing the security.' " *Johns Hopkins University*, *supra* 422 F. 2d at 1128. This *minimal communication* was that Hughes *could* lose everything on this subordination scheme, and that Peck's data, at best, was predicated on certain strategically vulnerable assumptions. In essence, Peck's message [43; 1214] was that the subordination scheme was a vastly complicated calculated risk. Since Peck more than adequately communicated this material fac-

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rial information is essentially premised upon the combined oral representations of March 23 from Walraven and Whitney, and, insofar as they reinforced or otherwise contributed to the representations of the former two, the representations of Peck and Uhlir.

tor to Hughes, Dempsey as a principal, and the Exchange as a "controlling person," cannot be held accountable to Hughes under either of the Federal securities acts *based upon Peck's representations alone*. That Hughes apparently did not assign predominant consideration to Peck's views, or for other reasons, *see* discussion, *supra* at 35-36, assigned his assessment priorities elsewhere, is irrelevant for this very narrow question. Thus, removing Peck's representations from the liability theory equation, Walraven and Whitney's representations as separate and joint factors remain. (The facts indicate that Uhlir's representations were inconsequential as a factor in influencing Hughes' decision.) Although Walraven has been dismissed out of this action, his representations, individually and in conjunction with those of Whitney, are important for the determination of Dempsey's, and the Exchange's posture under the relatively broad areas of liability contemplated by section 10(b) and section 17, under the diffuse concept of fiduciary duty allowable under the "controlling person" statutes, and under the relatively narrow common law concepts of agency, and of aider and abettor. *See* discussion *supra* at 26-28.

Thus, at this point, the roles and representations of Walraven and Whitney would appear to be dispositive to the outcome of Hughes' claims. As previously determined, the relationship of these two men vis-a-vis Hughes extended beyond the formal, strictly defined lines of an ordinary business relationship into an unrestricted association between longstanding friends, with all of the attendant implications as to intimate communing and implicit exchange of ideas. *See* discussion, *supra* at 2-3 and 17-19. In light of this status, the overwhelming preponderance of that which was

communicated to Hughes by Walraven and Whitney stemmed not so much from a dispassionate and intimate *knowledge*, as to the accounting intricacies and capital condition of Dempsey, as it did from a visceral need to convey an *impression*, obviously unfounded on hard objective analysis, about a securities scheme which just seemed to be a [44; 1215] fine idea at the time. In essence, Walraven and Whitney simply communicated an over-simplified, self-serving hunch that everything would work out all right, and to Hughes' ultimate benefit. That neither Walraven nor Whitney were experienced professionals, adequately trained for the making of such far-reaching predictions about Dempsey's posture under the circumstances, is rather clear from the facts available to Hughes at the time. It is also bordering on the incredible that Hughes did not easily arrive at this conclusion *given* the overriding and persuasive admonitions offered by Peck—indeed, Peck was able to offer an unqualified rebuttal of the advice offered by Walraven, Whitney and Uhlir at the time that such advice was communicated. Thus, there was no time frame factor to distort the total picture of Dempsey projected by the four men.

At this juncture, certain conclusions must be emphasized in the following order: (1) Peck more than adequately communicated to Hughes his *professional* opinion that the subordination scheme envisaged for Dempsey was, at best, a calculated risk for the following general reasons: (a) Peck's projections as to the viability of the scheme were based upon data which should have generated a strong presumption of uncertainty by a reasonably prudent investor; and (b) Peck's projections as to Dempsey's recovery were based upon yet another, but highly contingent, presumption

that market conditions would continue to favor the reorganization of that faltering firm (*see* discussion, at 4-44 *passim*); (2) thus, Hughes had *actual knowledge* of all the *material facts available* to a reasonably prudent investor during the period in which he was considering entering into a securities transaction (obviously, a "material" factor substantially contributing to the failure of Dempsey was the subsequent general market deterioration, which however, was unforseeable, and thus nondisclosable); (3) therefore, Hughes *intentionally* entered into into the Dempsey subordination agreement with *full* knowledge of his available rights and alternatives under the circumstances; and (4) consequently, the *defense of waiver* is available to Whitney, and to Dempsey as Walraven and Whitney's principal, 10(b) and Rule 10b-5. [45; 1216] *See Royal Air Properties, supra,* 333 F. 2d at 571. There was a plethora of signals available to Hughes on the eve of subordination, within sufficient time for a more detailed examination, which strongly suggested that he should have abstained from the investment venture, unless of course he simply wished to assume the risk. At this point in time, Peck had equalized the market risk for both Dempsey, as his principal, and for Hughes, as prospective investor. *See Securities and Exchange Commission v. Texas Gulf Sulphur,* 401 F. 2d 833, 851-852 (2nd Cir., 1968) *en banc; cert. denied* 394 U.S. 796 (1969). In terms of equalizing Hughes' access to information, and to either investment rewards or financial disaster, Peck's performance satisfied Dempsey's obligations under the Securities Exchange Act. *See* 1 Bromberg, *supra* at §3.2(400); *see also* 2 Bromberg, *supra* at §8.4(650)(1). The Court is not prepared to conclude that Hughes was gullible to the

point of excess, but it also is not prepared to conclude that Hughes did not fully comprehend the gravity of his decision to subordinate his prime securities to the Dempsey reorganization effort. In terms of timing and impact, there was no event in this case other than the third and final meeting on March 2, 1970 which was "better calculated to bring [Hughes'] rights to his attention." *Royal Air Properties, supra,* 333 F. 2d at 572. Whitney and Dempsey thus being allowed to invoke the defense of waiver to the section 10(b) and Rule 10b-5 claims, Hughes is denied recovery as well under section 12(2) and 17 of the Securities Act, and, additionally, is unable to rescind the subordination agreement under section 29(b)(1) of the Securities Exchange Act, 15 U.S.C. 78cc(b)(1).

Assuming arguendo, that Whitney and Dempsey would not be able to invoke successfully the defense of waiver, the discussion will return to the potential liability of the Exchange under the remaining four theories previously mentioned. *See* discussion, *supra* at 38.

With respect to the "controlling person" theory, the questions sketched previously should be reasserted. *See* discussion, *supra* at 42. The Exchange will be liable as a "controlling person" to Hughes under the Securities Act only if it had knowledge of, or reasonable ground to believe [46; 1217] in the existence of, the representations which were made by Walraven and Whitney prior to or during the March 23rd discussion, and under the Securities Exchange Act only if it did not act in good faith *and* directly or indirectly induced said conduct or representations by Walraven and Whitney. *See Strong, supra.* A more refined test for liability

of a "controlling person" which has been applied states that, to demonstrate good faith conduct, the "controlling person" must show that "precautionary measures were taken to prevent the violation," and that the failure of the "controlling person" "to maintain and diligently enforce a proper system of internal supervision and control constitutes participation in the misconduct." *Hecht, v. Harris, Upham & Co.* 283 F. Supp 417, 438 (N.D. Calif., 1968); *aff'd,* 430 F. 2d 1202 (9th Cir., 1970); *mod'd on denial of rehear.* (1970). The answer to this test lies in the conduct of the Exchange vis-a-vis Dempsey, thus including Walraven and Whitney, and vis-a-vis Hughes prior to and contemporaneous with the subordination. The pertinent facts appear to be as follows: (1) the Exchange, although allowing Dempsey to continue operations on a restricted basis, nevertheless severely curtailed said operations and strongly admonished its leadership—indeed, the incumbent leadership at the inception of Dempsey's difficulties was removed in substantial measure; (2) the Exchange, through its *almost* daily contact with the Commission prior to the two subordinations, and through its careful representations as to the conditions under which subordination would occur, clearly conveyed an official posture that Dempsey was in trouble, and that it would be difficult, if at all possible, for it to recover; and (3) Walraven and Whitney, retained as duly authorized representatives of Dempsey after the Exchange imposed its reorganization effort, failed to convey this overall posture to Hughes, which posture, as indicated earlier, essentially viewed the subordination scheme as, at best, a calculated risk investment scheme, which, under continued favorable conditions, would result in mutual benefits for all

parties concerned. The question is whether the Exchange could be held liable for the ranging representations made to Hughes on March 23, 1970 by Walraven and [47; 1218] Whitney, or for the prior conduct which they exhibited toward Hughes which might have contributed to his final decision.

Under the circumstances, notwithstanding the previously acknowledged, diffuse concept of fiduciary duty for which a "controlling person" must be responsible, there are certain characteristics of that which was communicated to Hughes from Walraven and Whitney over which the Exchange, and no one else for that matter, had "control." An attempt was made to define the nature of the relationship from which such representations sprung. *See* discussion, *supra* at 42-45. This relationship also is in marked contrast to the *formal lines of communication* established between the Exchange and Hughes, directly, and the *formal manner* in which such communications were made. The point is that, with the exception of the generalized observations of Dempsey offered by Walraven and Whitney, the ostensible projection of Dempsey's condition afforded by those authorized representatives of the Exchange, or by Peck, as an "indirect" representative of the Exchange, was at once very complex and conservative. *See for example,* discussion, *supra* at 38-41. In this respect, Walraven and Whitney's conduct and representations differed sharply in impact and final effect from those of the Exchange, or of Peck.

Still, these two men were agents of Dempsey, and, indirectly, under the "control" of the Exchange, insofar as the Exchange had the power to restrict Dempsey to the point of closing its business, or even suspending it altogether. But, their representations and

conduct, essentially confined to the March 23rd discussions, totally deviated from the posture of cautious recommendation of the subordination scheme espoused by the Exchange. This posture was *clearly evidenced* in the Exchange's relationships with the Commission, King and the Dempsey reorganization effort itself (most noticeably demonstrated in Peck's presence and performance). Thus, to find failure by the Exchange in taking appropriate "precautionary measures," or in maintaining "a proper system of internal supervision and control" would be exacting a requirement for it to monitor on a daily basis the informal superlatives constantly traded by executives [48; 1219] of "controlled persons" in circumstances and under conditions which extend far beyond the confines of business office activities. More simply stated, much of that which was communicated to Hughes by Walraven and Whitney on the subordination scheme was done over such a period of time, and under such informal conditions, that neither of the two men apparently either sufficiently apprised themselves of the facts, or of the legal implications for such communications for themselves, for Dempsey or for the Exchange. The question must be posed to what limits does the obligation of a "controlled person" extend under the circumstances of a case of this nature? Does it include the duty to "control," or otherwise "qualify," the most casual thoughts which appear in the context of an informal message. To state it in a different fashion, did the Exchange have the right to presume that, under the circumstances, Walraven and Whitney would put their thoughts in context, and limit their recommendations when they should have known of the uncertainties to be weighed and considered by Hughes. It seems that a contrary condition would have placed

the Exchange in an impossible quandary—either stifle the common puffing of business ventures which occurs between business acquaintances, or unconditionally impose restrictions or suspension proceedings upon a member firm such as Dempsey. Under the circumstances, it would be unreasonable to conclude that the Exchange failed to take appropriate "precautionary measures" to prevent the misrepresentations of Walraven or Whitney, or that it failed to maintain and diligently enforce "a proper system of internal controls." To conclude otherwise would create a foundation for liability of a "controlling person" for conduct taking place beyond the very system of controls which were in fact established, and would again appear to border upon a theory of strict liability as to any and all conduct which may pertain to the scheme in question, however remote, and over which the Exchange had no right to expect control or influence. The Exchange cannot be held accountable for that which it did not nurture, encourage, condone, sanction, or otherwise induce, and, although it must be deemed to have been a "controlling person" under the circumstances, it could not be have the right to presume that, under the circumheld liable [49; 1220] for Walraven and Whitney's representations under this theory under either of the two Federal securities laws.

The next theory of liability which follows is the Exchange's duty under section 10(b) and Rule 10b-5 promulgated thereunder. A discussion of the elements of a claim against the Exchange under section 10(b) would essentially parallel the examination of the section 6 duty, as contemplated within the framework of this particular case, and of the "controlling person" duty, again, as set forth under the unique circumstances of the case. *See* discussion, *supra* at 37-41

and 42-45. This is not to say that the section 6 and section 10(b) theories of liability are congruent. However, it would appear that the *conduct* of the Exchange, *in light of* its section 6 responsibilities toward Hughes as a proposed subordinator of Dempsey, would promote the disposition of the question whether the Exchange could be held liable under section 10(b). Thus, a repetition of the foregoing analysis is unnecessary. For purposes of a section 10(b) inquiry perhaps only a few additional questions need be posed: (1) whether Hughes' participation as a proposed and ultimate subordinator of securities in this case entitles him to protection under section 10(b); and (2) whether the *overall posture and activity* of the Exchange in this case, vis-a-vis *all relevant persons* participating in the Dempsey rescue effort, amounted to an *operation or scheme* which could subject the Exchange to liability for Hughes' losses under section 10(b). The answer to the former question is obvious, and in the affirmative. The latter question poses the broadest conceivable protection for Hughes for liability-creating conduct under the Securities Exchange Act. *See Walling v. Beverly Enterprises*, 476 F. 2d 393, 396 (9th Cir., 1973). The section 6 duty and its fulfillment by the Exchange, *see* discussion, *supra* at 41 would appear to satisfy at least the test whether the Exchange exercised its primary *affirmative* responsibility to formulate, abide by, and enforce rules pertaining to Dempsey which are consistent with the purposes of Chapter 2B, and otherwise "consistent with just and equitable principles of trade." Thus, this broad duty by implication, and at the very least, would seem to require as part of com- |1221| pliance therewith an *unconditional avoidance* of any participation whatsoever within any

device or scheme which might submit a national securities exchange within the section 6 charge to the *potential* liability of the extensive protection available to investors contained within section 10(b). The very fulfillment of the affirmative section 6 duty by an exchange would seem to be totally inconsistent with participation in *any* conduct violative of Chapter 2B. Thus, the only theory by which Hughes could seemingly reach the Exchange under section 10(b) would be by its participation "on the fringe" of any effort or scheme not included within the precisely drawn compass of its section 6 duty and participation in this case. This question may be answered indirectly by simply noting that the Exchange was the major protagonist in this case —the Exchange's activities touched every relevant facet of this case, from the preservation of Dempsey initially from suspension proceedings to the final offering and acceptance of the Hughes' subordination agreement. Thus, there are no operative facts in this case simultaneously contemplatable within section 10(b) with which the Exchange was not involved. The only question is whether the Exchange's conduct was liability-creating. In this sense, the section 6 and section 10(b) liabilities cannot be divorced from one another in this case. Since the Court has previously determined that the Exchange performed its section 6 duties adequately by devising the very scheme with which it sought to rescue Dempsey from difficulty, it could not conversely find that that scheme, as devised, and as specifically portrayed to Hughes by persons acting *consistent with* the Exchange's concept of that scheme, subjected the Exchange to Hughes' recovery under section 10(b). (It must also follow that neither could Hughes succeed in recovering against the Exchange under either section 12(2), or section 17 of the Securities Act.)

With respect to the Exchange, this leaves only two remaining theories of liability by which it could be reached—the general duty of the fiduciary, and the status of an aider and abettor at common law. Hughes predicates his fiduciary duty theory on the view that, as an "insider," with greater access to and control over the sources of material information. [51; 1222] the Exchange owed a paramount duty to him to disclose all that it knew which might have a bearing upon his decision to subordinate. Thus, this theory would find the Exchange liable if it had access to material information which it did not disclose to Hughes, thus precluding his ability to reach an independent conclusion based upon his own evaluation of all the material data. *See Securities and Exchange Commission v. Texas Gulf Sulphur, supra* at 848-849; §16, Securities Exchange Act, 15 U.S.C. 78p. *Assuming* that the other elements of a section 16 action were presented,[31] nevertheless this theory would fail on two important particulars: (1) the Exchange did disclose all data material to Hughes' decision to subordinate, which it could gather at the time of the last meeting on March 23, 1970; and (2) the Exchange did not have access, nor could it have gained access, to that data which would have provided a dispositively material bearing upon the viability of this particular subordination, more specifically any indicators pertaining to the subsequent, unforeseeable intervening force of general market deterioration and collapse. In any event, it would seem that the Exchange's duty as a "controlling person," and its section 6 duty

[31]It should be noted that Hughes did not plead a section 16 action against the Exchange. This discussion, therefore, is for the limited purpose of amplification of the fiduciary duty characteristic of such an action as it *might* be applied in the context of the common law claims alleged.

would appear to encompass any disclosure responsibilities as to material information based upon a section 16 status. As noted before, the section 6 and section 15 "controlling person" duties, have been deemed to extend beyond the duties of a mere fiduciary at common law. *See* discussion, *supra* at 26-27 and 35. For example, the duty as conceived in *Baird, supra* at 246, would appear to be one not only encompassing the exercise of great care in responding to events of general concern, but requiring prompt, affirmative action on the part of the Exchange to investigate particular events, which come to light with respect to a member dealing with any investor, which may raise questions as to the propriety of said events under the Securities Exchange Act. This high standard of conduct, and burden of defense as to the propriety of responses in such situations, devolves from the Exchange's superior access to and comprehension of the data pertaining to the member's transactions in question. Inasmuch as the Exchange, under the cir- [52; 1223] cumstances of this case, has been deemed to have met its obligations under section 6, and section 15 and section 20, it has at once fulfilled its general fiduciary duties toward Hughes under a hypothetical section 16 claim, and under the common law.

The standards which elucidate the status of an aider and abettor at common law are rather strictly drawn, and can be easily placed within the meaning of the consequences flowing from the term "induction" discussed under the Exchange's status as a "controlling person." Briefly, an aider and abettor may be liable for the misrepresentations or material omissions of another person *only* if he knew of the wrong being committed by the primary wrongdoer, *and* knowingly gave substan-

tial assistance or encouragement to said wrongdoer in the commission of that action. *See Brennan, supra,* at 724-725; *Fischer v. Kletz,* 266 F. Supp. 180, 197 (S.D.N.Y., 1967); *Pettit, supra* at 28. Since the Exchange did not induce the misrepresentations and omissions of Walraven and Whitney under the "controlling person" liability test discussed previously, the Court would be foreclosed from finding the Exchange's participation to the extent required to subject itself to liability under the aider and abettor test at common law. Accordingly, on all five theories advanced, and with respect to both broad instances of conduct, *see* discussion, *supra* at 38, the Exchange is not, and could not, be found liable to Hughes under either the two Federal securities laws or the common law.[32]

[32]Although mooted as an issue, for purposes of making the discussion further complete, the "knowledgeability letter" signed by Hughes and mailed to the Exchange as part of the subordination agreement should be given brief attention. The Exchange contends that this letter, *on its face,* constitutes a waiver of Hughes' recourse to the remedies under the Federal securities laws This position is without foundation. The Exchange appears to focus upon two points: (1) the letter does not pretend to waive compliance by the Exchange with the securities laws; and (2) the letter acknowledges the position that Hughes is not the type of investor the laws were designed to protect. The latter point raises arguments which have heretofore been dismissed as without merit. The former point begs the question whether the letter has any validity in its attempt to waive Hughes' *recourse* to the securities acts. It would appear that the remedial provisions of the Securities Act could not be waived as a matter of policy under section 14 of that Act, 15 U.S.C. 77n. *Wilko v. Swan,* 346 U.S. 427, 432-436 (1953). The same logic applies with equal force to remedies provided under section 29(a) of the Securities Exchange Act, 15 U.S.C. 78cc(a). *See Moran v. Paine, Webber, Jackson & Curtis,* 389 F. 2d 242, 245-246 (3rd Cir., 1968); *Special Transportation Services, Inc. v. Balto,* 325 F. Supp. 1185, 1187 (D. Minn., 1971).

Also, at this juncture, it might be appropriate to briefly examine Hughes' alternative theory of recovery against the Exchange on a third-party beneficiary argument, based upon the liquidation

(This footnote is continued on next page)

This leaves for the balance of the discussion the liability of Dempsey and Whitney under the remaining causes of action advanced. The question of their liability under the Federal causes of action has already been determined. *See* discussion, *supra* at 44-46. This leaves for determination the common law causes of action against Dempsey and Whitney. Hughes alleges violations of section 1710(1)(3), Cal. Civil Code (West, 1954) and of section 25401, Cal. Corp. Code (West, 1955). The latter encompasses essentially the same ele-

agreement consummated between the Exchange and Dempsey in August 1970 by which the Exchange made available its trust funds to Dempsey creditors. This question has been previously confronted in a slightly different context in *Weinberger, supra* at 142-145. In that case, the Court concluded that the agreement filed with the Commission by the Exchange, pursuant to the statutory mandate under section 6 of the Securities Exchange Act, created an obligation on the part of the Exchange toward those members of the class that section was designed to protect. That Court found a basis for such a third-party beneficiary theory existing both under New York and Federal common law. It would appear that California similarly affords a basis for third-party relief under an agreement concluded pursuant to a statutory scheme, provided that that person is identifiable within the protected class. *Division of Labor Law Enforcement v. Dennis,* 81 Cal. App. 2d 306, 183 P. 2d 932, 933-934 (1947); *MacKay v. Loew's Inc.,* 182 F. 2d 170, 172 (9th Cir., 1950); *see* Cal. Civil Code, §1559 (West, 1954); *Lucas v. Hamm,* 56 Cal. 2d 583, 364 P. 2d 685, 15 Cal. Rptr. 821 (1961) *rehear. denied en banc* (1961); *cert. denied,* 368 U. S. 987 (1962). Since the agreement in the instant case between the Exchange and Dempsey was drafted pursuant to a statutory charge (section 6) which charge contemplated the protection of investors such as Hughes, and since Congress intended to provide a remedy for breach of the section 6 obligation, Hughes can pursue a cause of action as a third-party beneficiary under the liquidation agreement *provided* that he demonstrate that the section 6 obligation was not performed by the Exchange in the events leading up to the August 1970 agreement. Since the Exchange had fully performed its section 6 obligation toward Hughes, its subsequent entering into an agreement with Dempsey, also as part of its section 6 duty, did not have the effect of creating a basis for Hughes to claim third-party beneficiary status. Accordingly, the Court cannot award declaratory judgment in favor of Hughes on this third-party beneficiary theory of recovery.

ments [53; 1224] as those set forth under section 12 (2) of the Securities Act. Accordingly, since Dempsey and Whitney have been found not liable under this Federal statutory scheme, which encompasses the elements of this cause of action under the California State corporations code, they are also held not liable under section 25401 of that statute. Section 1710 provides various circumstances for actionable deceit at common law. Generally, Whitney's representations, as a whole and on their face, were more in the nature of opinions and not representations of fact. Under such a limited instance, deceit ordinarily does not lie under this statute. *See Daniels v. Oldenburg,* 100 Cal. App. 2d 724, 224 P. 2d 472, 474 (1950). Notwithstanding two important elements existing in this action: (1) Whitney's status as a fiduciary to Hughes, which resulted from his corporate relationship and responsibilities owed toward Hughes; and (2) Whitney's representations in the context of the March 23rd meeting which, taken in light of all factors and under the circumstances, had a reasonable tendency to be taken by Hughes as assertions of fact, Whitney is found not to have committed actionable deceit under section 1710 (2) and (3), for the reasons pertaining to the defense of waiver previously discussed. *Cf. Hobart v. Hobart Estate Co.,* 26 Cal. 2d 412, 159 P. 2d 958, 968 (1945); *Daniels, supra* at 474-475; *Mathewson v. Naylor,* 18 Cal. App. 2d 741, 64 P.2d 979, 981 (1937). Similarly, under the principles of agency heretofore examined at length, Dempsey is also found not liable under section 1710 of the California State Civil Code.

The final subject which should be considered concerns the nature of relief which might have been accorded to Hughes if he had prevailed. Since the sub-

ordination agreement contemplated a fixed return in consideration for the use of Hughes' capital, the "rescission" measure of damages, *see Esplin v. Hirschi,* 402 F. 2d 94, 104-105 (10th Cir., 1968); *rehear. denied* (1968); *cert. denied,* 394 U.S. 928 (1969), would have been inadequate, and the "benefit of the bargain" rule would have seemed to be the most equitable, since it would have provided Hughes with his out-of-pocket losses *plus* the value of that interest which he would have received [54; 1225] had the subordination scheme succeeded. *Hartwell Corporation v. Bumb,* 345 F. 2d 453, 457 (9th Cir., 1965). In this respect, the "benefit of the bargain" standard is in accord with the "actual damage" standard set forth in section 28(a) of the Securities Exchange Act, 15 U.S.C. 78bb. *See Walsh v. Hooker and Fay,* 212 Cal. App. 2d 450, 28 Cal. Rptr. 16, 22-24 (1963); *Northwestern Title Security Company v. Flack,* 6 Cal. App. 134, 85 Cal. Rptr. 693, 699 (1970); *Munger v. Moore,* 11 Cal. App. 3d 1, 89 Cal. Rptr. 323, 329 (1970); *see also McDonnell v. American Leduc Petroleums, Ltd.,* 456 F. 2d 1170, 1182-1183 (2nd Cir., 1972). Hughes' prayer for relief also contemplated singular punitive damages against the Exchange. It might be appropriate to make the following comments for the sake of completion of discussion. Although the Ninth Circuit would appear to allow for punitive damages under a general theory of tort arising from a statutory violation as claimed in this instance, *Hecht, supra* 283 F. Supp. at 444-445, and the Securities Act does not contain provisions analogous to the "actual damage" limitation contained in section 28(a) of the Securities Exchange Act, thus creating no apparent bar to the imposition of such damages in this case, the Court does

not feel that, under the circumstances, the facts would have supported any imposition of punitive damages against the Exchange. Such an imposition would have to be premised upon a conclusion that the Exchange's conduct was tantamount to a wilfull disregard for the consequences which might have befallen Hughes, and such a finding, in the opinion of the Court, would be totally inconsistent with and unsupportable in light of its prior finding that the Exchange's actions, viewed as a whole, were implemented in good faith.

Implicit in the length and structure of this opinion is the impression that both the plaintiff and the defendants held firm convictions and bona fide beliefs as to their respective positions on the merits of the several claims advanced. In light of this conclusion, the awarding of attorney's fees to either side over the other would amount to a blind disregard for these convictions and beliefs, indeed, it would prescribe a plainly inequitable ending to the litigation. Accordingly, each of the respective [55; 1226] parties shall bear its own costs as incurred for the maintenance of this action.

Dated: 9/4/73.

/s/ Malcolm M. Lucas
Malcolm M. Lucas
United States District Judge [1227]

Judgment.

United States District Court, Central District of California.

Reuben P. Hughes, Plaintiff, v. Dempsey-Tegeler & Co., Inc. a Delaware corporation, Lewis Whitney, James Walraven, and New York Stock Exchange, Inc., a New York corporation, Defendants. No. 71-1299-MML.

FILED: Sept. 6, 1973.

This action came on for trial before this Court, and the issues of fact and law having been duly presented and tried, and a decision having been duly rendered thereon as fully set forth in this Court's Memorandum Opinion dated September 4, 1973,

IT IS THEREFORE ORDERED AND ADJUDGED, that the plaintiff, Reuben P. Hughes, take nothing by his complaint, that the action be dismissed on the merits, and that each of the respective parties participating in this action shall bear its own costs as incurred for the maintenance of this action.

Dated: September 4, 1973.

/s/ Malcolm M. Lucas
Malcolm M. Lucas
United States District Judge

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 73-3591

REUBEN P. HUGHES,

Plaintiff-Appellant,

vs.

DEMPSEY-TEGELER & CO., INC., a Delaware corporation, LEWIS WHITNEY, JAMES WALRAVEN and NEW YORK STOCK EXCHANGE, INC., a New York corporation,

Defendants-Appellees.

(Opinion)

[March 29, 1976]

Appeal from the United States District Court
for the Central District of California

Before: JUDGES TRASK and SNEED, Circuit Judges, and RENFREW,* District Judge

RENFREW, District Judge:

This is an appeal from the judgment of the district court below dismissing plaintiff's action following trial to the court. Plaintiff-appellant is Reuben P. Hughes (''Hughes''), a businessman and private investor whose business activities include serving as a director and officer of Reynolds Industries and as a director of El Camino Bank in Anaheim, California. Defendant-appellee Dempsey-Tegeler & Co., Inc. (''Dempsey'') was a Delaware corporation engaged in the

*The Honorable Charles B. Renfrew, United States District Judge for the Northern District of California, sitting by designation.

general business of a broker-dealer in securities as a member organization of the New York Stock Exchange. Defendant-appellee Lewis Whitney (''Whitney''), was an officer of Dempsey during the period relevant to this action. Defendant-appellee New York Stock Exchange, Inc. (''Exchange'') is a New York nonprofit corporation registered as a national securities exchange with the Securities and Exchange Commission.

Hughes sued defendants below in an attempt to recover losses he sustained when securities subordinated by him in favor of Dempsey were sold for the benefit of Dempsey's creditors when that firm was liquidated. He alleged that he had been induced to enter into the subordination agreement because of various misrepresentations and failures to disclose material facts by the defendants. He further alleged that the Exchange had breached its duty to enforce its rules against Dempsey and that his loss was an actual and proximate result of that breach.[1] Following trial the district court issued an extensive memorandum opinion dismissing Hughes' action.

[1]Hughes' complaint alleged claims based upon the Securities Act of 1933, the Securities Exchange Act of 1934, California statutory law, and the common law. The first claim alleged a violation of Section 10(b) of the Securities Exchange Act, 15 U.S.C. §78j, of Rule 10(b)-5 promulgated thereunder, and of Sections 12(2) and 17 of the Securities Act, 15 U.S.C. §§771(2) and 77q by Dempsey, Whitney and defendant James Walraven (who was dismissed before trial). The second claim alleged a violation of Section 29(b) of the Securities Exchange Act, 15 U.S.C. 78cc(b), and of Section 12(2) of the Securities Act by Dempsey and sought rescission of the subordination agreement between Hughes and Dempsey based on the violations by Dempsey alleged in the first claim. The third, fourth, and fifth claims alleged violations by the Exchange of Section 6 of the Securities Exchange Act, 15 U.S.C. §78f, Section 10(b) of the Securities Exchange Act, Rule 10(b)-5, and Sections 12(2) and 17 of the Securities Act. The sixth claim sought declaratory relief against the Exchange. The seventh claim alleged a violation of Section 1710 of the California Civil Code, and of Section 25401 of the California Corporations Code by Dempsey.

Hughes v. Dempsey-Tegeler & Co., Inc. [1973 Transfer Binder] CCH Fed.Sec.L.Rep. ¶94,133 (C.D.Cal. 1974).

In his appeal Hughes has challenged the holding of the district court on each of the theories of recovery under the federal statutes set out in his complaint.[2] In our view, we need only address three basic questions to resolve this appeal. First, did the district court apply the correct legal standard in determining whether the Exchange had satisfied the duty imposed upon it by Section 6 of the Securities Exchange Act, and, if so, was its application of that standard to the facts sustainable on appeal? Second, assuming that the Exchange did breach its duty under Section 6, is Hughes precluded for any reason from recovering damages sustained as a result of that breach? Third, and finally, was the district court's finding that Hughes had received complete disclosure of all the material information concerning his subordination decision clearly erroneous?

[2]Hughes has raised the following issues on this appeal:

1. Whether the Exchange violated its statutory obligation and "agreement" under Section 6 of the 1934 Act by failing to suspend Dempsey prior to Hughes' subordination.
2. Whether the Exchange violated its statutory obligation and "agreement" under Section 6 of the 1934 Act by lifting all discipline from Dempsey on or about March 19, 1970, prior to Hughes' subordination.
3. Whether the Exchange, Dempsey, Whitney or Walraven violated Sections 12(2) or 17(a) of the 1933 Act, Section 10(b) of the 1934 Act or Rule 10b-5 by making or participating in material or misleading representations affecting Hughes' subordination.
4. Whether the Exchange, Dempsey, Whitney or Walraven violated Sections 12(2) or 17(a) of the 1933 Act, Section 10(b) of the 1934 Act or Rule 10b-5 by breaching an affirmative duty to disclose all material facts to Hughes.
5. Whether the Exchange violated Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act and Rule 10b-5 by participating in a course of business that operated as a fraud on Hughes.
6. Whether the Exchange violated Section 15 of the 1933 Act or Section 20(a) of the 1934 Act by failing to prove it acted in good faith to prevent the fraud on Hughes by Dempsey, Whitney and Walraven.
7. Whether the Exchange participated in, aided or abetted the federal securities violations of Dempsey, Whitney or Walraven.
8. Whether the District Court's finding that Hughes had actual knowledge of all material facts affecting his subordination was clearly erroneous.

We affirm the court below but for reasons different than those set out in its memorandum of opinion.

FACTS

The allegations in Hughes' complaint, particularly those against the Exchange, require that the focus of this opinion extend considerably beyond the subordination agreement between Hughes and Dempsey. In order to facilitate the presentation of the complex factual setting of this case, the relevant events are discussed in three phases. First, the developments in the securities industry during the relevant period are sketched. Then, the particular problems facing Dempsey and the responses to those problems by the principal actors are described. Finally, the series of events leading up to the execution of the subordination agreement by Dempsey and Hughes is examined. Although these phases have been isolated for purposes of exposition, they in fact constitute an interwoven fabric.

The chaotic condition of the securities industry in this country in the late 1960s and early 1970s provides the primary backdrop for this case. Between 1964 and 1969 stock market trading volume more than doubled, but the ability of brokerage firms to process their transactions failed to keep pace. Because the securities industry operated through the actual physical transfer of securities, problems at one brokerage house soon spread to other houses. Initially, this crisis was an operational one in which accounting systems broke down under the volume of business. However, the operational crisis frequently engendered financial problems. Be-

cause brokerage houses obtain part of their operating capital from the cash and securities they hold for customers, the confusion in accounting and the physical loss of securities deprived the firms of the use of capital which would otherwise have been available.

The problems of the securities industry were severely compounded by a precipitous decline in stock prices beginning at the end of 1968. By May of 1970, the Dow-Jones Industrial Average had fallen 354 points from the high of 985.2 reached late in 1968. The decline in stock prices adversely affected brokerage houses in two ways. First, those firms whose capital reserves were in the form of securities suffered a loss of capital as the value of the securities declined. Second, a decrease in trading volume accompanied the price decline, seriously cutting into the commission income of the brokerage houses.[3]

It is against this grim background that the particular situation facing Dempsey and the responses of the various parties must be assessed. That Dempsey was especially hard hit by the problems facing the industry in general is not disputed. Dempsey used an internal accounting practice based upon a method of branch office reporting to various regional accounting centers. The district court found that "[t]his particular accounting operation coupled with marked deficiencies in managerial leadership were to make Dempsey particularly vulnerable to the dramatic vicissitudes which were to affect adversely the securities market in the late sixties." *Hughes, supra, at* 94,527.

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[3]This summary is drawn in large part from a student note describing the problems of the securities industry during this period: Note, "Exchange Liability for Net Capital Enforcement", 73 Colum.L.Rev. 1262 (1973).

The Exchange's involvement with Dempsey spanned a number of years. Because of violations of the Exchange's capital and record-keeping rules in 1964 and 1965, the Exchange had required Dempsey to centralize its accounting operations. When difficulties were encountered in effecting this change, Dempsey received permission to use two accounting centers. However, as late as December 1968, Dempsey continued to use a third accounting center in St. Louis. *Id.* at 94,527.

The series of events directly relevant to this case began on January 16, 1969, when the surprise 1968 audit of Dempsey by Haskins & Sells was received by the Exchange. In contrast to the preceding report which had apparently indicated no problems, this audit revealed "serious capital and accounting problems in violation of Exchange rules." *Id.* at 94,528. In response to the news of these violations, the Exchange invoked what the district court characterized as "a measured response against Dempsey by levying certain sanctions against its business and management", including a prohibition against advertising or adding more registered representatives, a limitation on the maximum number of weekly trades, and a requirement of an immediate infusion of capital. *Id.* Furthermore, in a consent to penalty signed April 15, 1969, the Exchange imposed fines on Dempsey and two of its top officials. Additionally, the consent included an agreement to resolve the firm's accounting and record-keeping problems by September 30, 1969. Failing that resolution, the firm was to be subject to further reduction so that only one accounting center could be used. In the event that such a reduction was required but not achieved, the firm was to be removed from the Exchange.

On September 18, 1969, Haskins & Sells released its audit of Dempsey as of June 1, 1969. *Id.* at 94,528. There can be no doubt about the seriousness of that report, revealing as it did a deteriorating situation with respect to every important measure of Dempsey's operational and financial condition. The district court noted that Haskins & Sells had "pointedly avoided the issuance of an unqualified opinion with respect to Dempsey's financial condition." *Id.* The court further stated that Dempsey's unresolved " 'short stock record differences' [indicating missing securities the owners of which are known] * * * exclusive of subordinate borrowings were 213.46 percent of its stated net worth, the worst in the industry, and placed that firm perilously close to insolvency in the event such differences were incapable of being resolved." *Id.* at 94,529.

Following the release of the Haskins & Sells audit on September 18, a meeting attended by representatives of the Commission, the Exchange, and Dempsey was held in New York on September 25 to discuss Dempsey's noncompliance with the Exchange's directives. The Exchange refused to extend the September 30 deadline. Therefore, pursuant to the April consent to penalty, Dempsey was ordered to retract its business so that one accounting center could be used. Shortly thereafter, Dempsey's President Jerome Tegeler, was suspended by the Exchange for a year, and Lewis Whitney was named by Dempsey to be president of the firm. Further restrictions were imposed by the Exchange by letter on October 23. Dempsey was ordered to close 50% of its branches and to prepare a schedule for the elimination of the accounting and record-keeping problems still facing it. At the same time, the Commission refused to approve any further underwritings by Dempsey. After this time, no further restrictions or penalties were imposed on Dempsey.

On October 24, 1969, another meeting was held by representatives of the Exchange, the Commission and Dempsey. The district court found that strong disagreement emerged at this meeting among some of the participants concerning the appropriateness of the response to Dempsey's problems, with the representatives of the Exchange prevailing over representatives of the Commission as to the severity of the sanctions to be imposed. The Exchange announced that it would not make its discretionary Trust Fund available to customers and creditors of Dempsey in the event that the Commission forced the firm into liquidation proceedings. The meeting concluded with the understanding that Dempsey would not be suspended and that the Exchange's program of restrictions would be continued.

There were further meetings and exchanges of letters among the representatives of the Exchange, the Commission, and Dempsey in the last part of 1969 and the first part of 1970. In March of 1970, as part of an understanding reached with the suppliers of new capital for Dempsey, the Exchange lifted its previously imposed restrictions from Dempsey. At the same time, the Commission agreed to lift its prohibition against new underwriting by Dempsey.

Turning now to the sequence of events by which Hughes became involved with Dempsey, it is appropriate to give a brief description of Hughes himself. The district court described Hughes as "an uncommon man, with an uncommon business acumen", *id.* at 94,526, an accolade which is apparently justified by Hughes' business accomplishments. Hughes was the motivating force behind Pacific Hawaiian Products Company (producer of "Hawaiian Punch"), a company which he led from very modest beginnings to great financial success. The district court summarized Hughes'

position in the business community at the time of the events in this case as follows:

> "By the spring of 1969, Pacific Hawaiian had merged with Reynolds Tobacco, subsequently named Reynolds Industries. Hughes became its largest individual shareholder, a member of the Board of Directors, and an officer of that organization. Hughes also became a director of the El Camino Bank in Anaheim, California, and of the Anaheim Stadium Corporation. In 1967, Hughes received the "Business Man of the Year Award" in Orange County. His net worth was $11,000,000.00, and his yearly income by 1969 from investments was at least $300,000.00." *Id*. at 94,526.

Hughes' contact with Dempsey began more than twenty years ago when he opened a securities account with the firm after solicitation by James Walraven. At about the same time, Hughes became acquainted with Whitney, then a general partner of Dempsey. The district court found that Walraven was not only a professional consultant to Hughes, but also his personal friend. Whitney later became a director of Pacific Hawaiian. Dempsey handled the two public offerings of Pacific Hawaiian stock which occured between 1955 and 1964.

Hughes' involvement with the attempted resolution of Dempsey's problems began early in 1969 when Walraven suggested that Hughes subordinate a substantial amount of securities to Dempsey to be used in meeting the Exchange's net capital requirements. In exchange for the use of his securities, Hughes was to be paid substantial interest on their face amount by Dempsey, while retaining the right to collect the interest and dividends paid by the issuers of the securities. On the advice of his personal attorney, Hughes elected to

postpone further consideration of the matter until the Haskin & Sells audit of June 1969 could be reviewed. When that somber report was issued, Hughes was sent a copy which was in his possession at all subsequent, relevant times.

Late in 1969, Dempsey began negotiations concerning a separate subordination agreement with John King, chief executive and primary stockholder of King Resources Corporation, a holding company with substantial assets. This proposed subordination agreement, like the one being negotiated with Hughes, represented an effort to obtain the capital which was one of the essential requirements for Dempsey's return to viability. King initiated a private in-depth investigation of Dempsey in order to assess the desirability of subordinating $7,000,000 in King Resources stock in favor of Dempsey. Although Hughes never read the report prepared for King, it is important to note that Walraven suggested to Hughes that he might want to discuss the question of subordination with King and even offered to make arrangements for Hughes' transportation. Although this offer was not accepted by Hughes, the negotiations between Dempsey and King were clearly a substantial factor in Dempsey's continuing negotiations with Hughes. Hughes was impressed that King, whose business judgment Hughes valued, was also considering a subordination agreement. Hughes had realized extensive profits from previous investments in King stock.

There were three principal meetings between Hughes and the representatives of Dempsey. In December of 1969 Hughes met with Walraven and Whitney to discuss the possibility of a subordination agreement. At that time, Whitney advised Hughes not to commit himself unless King followed through on his agreement. In February of 1970 Hughes met with Walraven and Whitney again, at which time Dempsey's

operating problems were specifically raised and discussed. Whitney told Hughes that it appeared that the King subordination would occur if, *inter alia*, all restrictions were lifted from Dempsey. Hughes authorized extensive negotiations between his securities counsel and Dempsey's outside counsel in St. Louis over the nature and structure of such a subordination agreement.

In February 1970, at the same time that Hughes was meeting with Walraven and Whitney, representatives of King, the Commission, and the Exchange met to discuss the King subordination. King had at first insisted that all restrictions be lifted from Dempsey prior to his subordination and that the Exchange certify that the loan would bring the firm into capital compliance. This demand was rejected by the Exchange, but an agreement was subsequently reached that the restrictions would be lifted after the subordination was effected. After the February 19th meeting, the Commission expedited the registration of the King stock, knowing that it was to be used for the Dempsey subordination. King executed his subordination agreement with Dempsey on March 19, 1970.

The third and final meeting between Hughes and the Dempsey representatives occurred on March 23, 1970, the day before the execution of Hughes' subordination agreement. In addition to Walraven and Whitney, this meeting was attended by Robert Peck, an executive vice president of Dempsey who had been employed specifically to formulate a plan to save Dempsey, and Slavik Uhlir, an accounting expert employed by Dempsey to assist with its operational problems. At this meeting Walraven and Whitney "conveyed an optimistic appraisal of Dempsey's dilemmas" and of the safety of Hughes' proposed subordination. *Id.* at

94,535. However, Peck gave a lengthy oral and documentary presentation which specifically disagreed with the optimism of Walraven and Whitney and detailed the problems facing Dempsey and the circumstances that would have to materialize if the firm were going to survive. He plainly informed Hughes that there was a substantial risk in the contemplated investment, and there was a "good chance" that he would lose his money if he went ahead with the subordination. The district court found that with respect to Peck's warnings, "Hughes just either dismissed them lightly, or decided to ignore them entirely." *Id.* at 94,536.

The next day, March 24, 1970, Hughes executed the documents of the subordination agreement upon notification that the King loan had been consummated and that the restriction against Dempsey had been lifted.

The stock market experienced severe losses immediately after the King and Hughes subordinations. The district court summarized this decline and its particular impact on Dempsey as follows:

> "The New York Stock Exchange Index declined by approximately 25 percent, the American Stock Exchange and over-the-counter averages declined by substantially greater amounts. The stock securing the King loan dropped from $23 per share in March 1970 to approximately $6 per share at the end of May 1970. On April 30, its market value had been $5.5 million ($14 per share); by May 22, its net value had declined to $2.7 million. By July 1970, there was no market for the King stocks, the market value had fallen to $1.50 per share. The precipitous decline of the stock market in general, and the King stock in particular, was disastrous for Dempsey." *Id.* at 94,536-94,537.

The decline in securities value also accompanied by a marked drop in volume of securities traded. The combined effect of these developments was fatal to Dempsey. On or about July 15, 1970, Hughes' subordinated securities were sold as provided in the subordination agreement. The liquidation of Dempsey was begun on August 7, 1970, when a liquidation agreement between Dempsey's voting stockholders and the Exchange was executed. As a result of his subordination, Hughes lost $1,271,600. The suit below followed.

THE EXCHANGE'S BREACH OF DUTY UNDER SECTION 6 OF THE SECURITIES EXCHANGE ACT

Hughes based his third, fourth and fifth claims on the alleged violation by the Exchange of the duties imposed on it by Section 6 of the Securities Exchange Act, 15 U.S.C. §68f.[4] Hughes argues that two distinct decisions taken by the Exchange in response to Dempsey's problems constituted a violation of its duty under that section: First, the decision not to suspend the firm in the fall of 1969 but instead to continue with the program of more limited restrictions; and second, the decision to lift the previously imposed restrictions from Dempsey in March of 1970 as part of the effort to attract additional capital for the firm. The district court held that the

[4]Although they have not pursued the point with any vigor, appellees have argued in their brief that Hughes lacks standing to bring a private right of action under Section 6. The basis of this argument is that Section 6 was intended to protect customers of brokerage firms such as Dempsey, and not to protect investors in such firms themselves. We agree with the careful analysis of this question in *New York Stock Exchange v. Sloan* [1974-75 Transfer Binder], CCH Fed.Sec.L.Rep. ¶95,083 (1975), in which Judge Lasker held that the legislative history and policy of the statute supported a finding that both subordinated lenders and limited partners were entitled to bring private actions for violations of Section 6.

Exchange had not breached the duty imposed on it by Section 6. Hughes challenges that conclusion.

Section 6 sets out the conditions for the registration of securities exchanges under the Securities Exchange Act. Applicant exchanges are required to submit their constitutions, articles of incorporation, and all other rules "whatever the name" so that the Commission can determine whether they are "just and adequate to insure fair dealing and to protect investors". Two provisions of Section 6 are of particular importance to a private cause of action such as Hughes'. First, Section 6 (a) (1) requires the applicant exchange to submit:

> "An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder".

Second, Section 6(b) establishes both a condition precedent and subsequent to the registration of any exchange:

> "No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this chapter or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade."

Shortly after the enactment of the Securities Exchange Act, the Exchange complied with the requirements of Section 6

and was granted registration under the Act by the Commission.

The Securities Exchange Act provides no express remedy for individuals who suffer loss as a result of an exchange's failure to enforce its rules. It is, however, well established that Section 6 does impose a duty upon an exchange to enforce the rules adopted pursuant to Section 6 and that a private right of action will lie to seek damages for injuries suffered as a result of an exchange's violation of that duty.[5] This appeal requires us to consider the dimensions of that duty when an exchange is aware of a violation of the Act or of its rules.[6] It is undisputed that Dempsey was in intermittent violation of the Exchange's net capital and reporting rules as early as 1964, and, more importantly, in continuous, serious violation of those rules from at least June of 1968 until its liquidation in August of 1970. The question is whether the

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[5]Private suits have been allowed against exchanges for violation of Section 6 on two legal theories. The first, established by the leading case of *Baird v. Franklin*, 141 F.2d 238 (2 Cir.), *cert. denied*, 323 U.S. 737 (1944), is essentially a tort theory in which the duty element is supplied by §6(b) of the Act. The second theory, suggested in the *Baird* case, *supra*, and subsequently adopted in *Weinberger v. New York Stock Exchange*, 335 F.Supp. 139 (S.D.N.Y. 1971), is that the private plaintiff can sue as a third party beneficiary of the agreement required by the §6(a) of the Act between the registered exchange and the Commission. In our view, the content of that duty is the same under either of the two theories.

The Supreme Court has, of course, recently handed down several decisions bearing on the question of whether a private right of action is to be implied under a statute which does not expressly provide for such a right of action. *See Cort v. Ash*, 422 U.S. 66 (1975); *Securities Investor & Protection Corp. v. Barbour*, 421 U.S. 412 (1975). The parties have not argued and we find no reason to conclude that the factors enunciated in those decisions mandate a reversal of the longstanding rule that a private right of action is available under Section 6.

[6]There is surprisingly little case authority on this question. Almost all reported cases involving Section 6 have turned on the question of whether the defendant exchange knew or should have known of the alleged violations of the Act or its rules. *See, e.g., Hochfelder v. Midwest Stock Exchange*, 503 F.2d 364 (7th Cir. 1974); *Butterman v. Walston*, 387 F.2d 822 (7th Cir. 1967), *cert. denied*, 391 U.S. 913 (1968).

Exchange's response to that known situation fell short of the obligations imposed by Section 6.

Hughes argues that the district court erred in taking into consideration certain factors that are inappropriate to an appraisal of the Exchange's duty under Section 6. Although the district court's opinion in this case of first impression reflects scholarship and prodigious effort, we are nevertheless convinced that with regard to the Exchange's decision to lift the restrictions from Dempsey the district court erred in finding no breach.

The district court discussed the question of the Exchange's Section 6 liability at several different points in its lengthy opinion. At one point, the court stated that the measure of the Exchange's Section 6 duty "depends to a certain extent upon Hughes' status, and to a greater extent, upon the nature and amount of information to which Hughes had access — or to which he should have had access." *Id.* at 94,539. We agree with Hughes that the extent of his information is irrelevant to the question of whether the Exchange has breached its duty to enforce its own rules. The question of Hughes' access to information is, however, a proper consideration in determining whether Hughes should be allowed to recover for any breach of the Exchange's duty which has occurred. At another point, the district court discussed the action taken by the Exchange and found that it had been taken in a "good faith effort to do principally two things: (1) rescue Dempsey, and thereby protect its creditors; and (2) prevent a general market loss of confidence, and thereby protect other firms within its responsibility." *Id.* at 94,544. The finding clearly represented a rejection of Hughes' argument that the Exchange had acted in a bad faith attempt to protect its own Trust Fund assets. Standing alone, the fact that the Exchange

acted in good faith is not a sufficient defense against an action brought under Section 6. As we discuss at more length below, the concern by the Exchange regarding the consequences of its action in the general securities market is perfectly legitimate and appropriate. When the district court actually decided whether the Exchange's action constituted a breach of its duty, it used entirely different terminology. Discussing the decision not to suspend Dempsey in the fall of 1969, the court found the decision was not "unreasonable", particularly in the light of the Exchange's desire both to save Dempsey and to avoid a general loss of confidence in the market. *Id.* at 94,546. This characterization of the standard in terms of reasonableness is similar to the approach we have adopted. It is not entirely clear whether the district court used the same standard in finding no breach in the Exchange's decision to lift the restrictions, a decision described by the court as "momentous [but] not an abuse of discretion, nor a violation of a statutory charge." *Id.* at 94,546.

Hughes has challenged the district court's determination that an exchange has some discretion or flexibility in performing its duty under Section 6. The district court clearly rejected the argument that an exchange has discretion as to whether to enforce its rules at all. Its apparent willingness to allow some flexibility in the exchange's determination of the appropriate response to a perceived violation of the rules is consistent with the approach we have adopted. There is, however, some indication that the district court may have perceived the options open to it too narrowly. It concluded its dismissal of Hughes' Section 6 claim by stating that:

> "A contrary finding under the section 6 theory of recovery would appear to place national securities exchanges in an impossible position of making an ultimate choice between two alternative courses of action — either to submit themselves to a form of strict liability for the potential risks inherent in the type of protective scheme devised to preserve Dempsey, or to forego equally important obligations — legal and ethical — to other members of their national organizations and their clients." *Id.* at 94,546.

We believe that the approach we have adopted below allows for the imposition of liability when the exchange has clearly breached its duty without creating the dilemma which concerned the district court.

Because of the impotance and complexity of the issues involved in a suit based on a violation of Section 6, we feel that it is useful to set out at some length our view of the appropriate standards. The only previous appellate consideration of the question now before us is the leading case of *Baird v. Franklin*, 141 F.2d 238, *cert. denied*, 323 U.S. 737 (1944). In that case, Richard Whitney, the senior partner in a New York Stock Exchange member firm, had wilfully converted to his own use a large number of securities which had been entrusted to him. Between November of 1937 and March of 1938, the Exchange had knowledge of Whitney's misdeeds but took no action against him. When Whitney's firm eventually failed, the owners of the securities which had been converted brought suit for their loss. The majority of the Court of Appeals for the Second Circuit affirmed the districts court's dismissal of the complaint on the ground that the plaintiffs had failed to meet their burden of proving that the Exchange's violations were cause of their loss. 141 F.2d at 239. Judge Clark dissented, taking a somewhat more liberal position regarding the proof of damages. More importantly,

his opinion is recognized as the dispositive analysis of the Exchange's duty and breach of duty under Section 6.

Judge Clark noted that one of the aims specified in the constitution of the Exchange was the promotion of "just and equitable principles of trade and business, and [that] any violation of this aim was punishable by expulsion from the Exchange." *Id.* at 241-242. This general aspiration was in turn defined in the consitution by reference to the particular provisions of the Act and the Exchange's rules. Judge Clark specifically listed the rules which Whitney had violated and concluded that:

> "The Stock Exchange, therefore, was under a duty on Whitney for the various violations of the Securities Exchange Act and the Rules of the Exchange which it either knew of or at least had reasonable cause to suspect. Its *complete inaction* for some two months was a dereliction of that duty and a violation of §6(b) of the Act." *Id.* at 244 (emphasis added).

Baird is of limited utility in the resolution of the instant appeal. As the district court below noted, in *Baird* the Exchange had assumed a role of "relatively total inaction" with regard to the violations. In contrast, in the instant case the Exchange "engaged in a carefully measured response with respect to the member firm, Dempsey, which *did* involve the invocation of *some* internal disciplinary action prior to the introduction of the claimant, Hughes, upon the scene * * *." *Hughes, supra,* at 94,545, emphasis in original. In *Baird,* Judge Clark did not have to consider the more difficult question of the sufficiency of an attempted response.

The only case to consider the question of when a positive response to a known violation of the act or rule is so inadequate as to constitute a violation of Section 6 is *Rich v.*

New York Stock Exchange, 379 F.Supp. 1122 (S.D.N.Y. 1974), *rev'd on other grounds,* Docket No. 74-2242 (2d Cir., July 8, 1975). The case involved the demise[7] of Weiss Securities, Inc. ("Weiss"), another member firm of the New York Stock Exchange. Placing special reliance on the Exchange's failure to enforce the net capital requirement of Rule 325, one of the rules also at issue in the instant case, plaintiff's alleged that the action taken by the Exchange after learning of Weiss' financial difficulties constituted a breach of its duty under Section 6.

Having assumed that a private right of action would lie under Section 6 for a failure to enforce Rule 325, the court held that: "The duty of the Exchange * * * to enforce compliance with its rules 'so far as within its powers' must be evaluated reasonably." 379 F.Supp. at 1126. The court found that:

> "From the time the Exchange received notice of Weiss' difficulties it acted with dispatch to discharge its statutory duties. The Exchange first conducted an intensive investigation and then approved a plan which called for a merger with Ladenburg, a stronger firm, preceded *pendente* by a transfer of some accounts from Weiss to

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[7]In *Rich* the Securities Investors Protection Corporation ("SIPC"), an entity created by Congress in 1970 in response to the problems of the securities industry exemplified by the instant case, had petitioned the district court for liquidation of Weis and for the appointment of an SIPC trustee. A trustee was appointed, and he proceeded to resolve the claims of the customers of Weis. (For a description of the SIPC procedure, see note 8, *infra.*) Because of the existence of the SIPC, the only apparent loss to customers was either the deprivation of their securities for a time or the necessity of taking cash rather than their actual securities. The case actually came before the court on defendants' motion for summary judgment on the ground that plaintiffs had no provable damages. In an unusual decision, the court held that it did not have to reach the damage issue which was properly before it, because "no cause of action exists in plaintiffs' favor." 379 F.Supp. at 1125.

> Ladenburg. [footnote omitted] The Exchange did not select the accounts to be transferred. Its procedure was in accordance with practices the SEC has acknowledged to be a proper and effective means of salvaging firms facing financial ruin. Had it been successful, no customers of Weiss would have been damaged or inconvenienced in any way." *Id.* at 1127.

On the basis of those findings, the court concluded that: "The Exchange's efforts to aid Weiss did not constitute a failure to fulfill its obligations." *Id.* at 1128. The court's approach in *Rich* is inconsistent with appellant's argument in the instant case that the response mandated by Section 6 was the immediate suspension of the firm by the Exchange upon learning of the violations. We concur in the wisdom of that approach.

Section 6 of the Securities Exchange Act imposes a duty upon registered exchanges to enforce the provisions of the Act and the rules promulgated pursuant to it. To hold that registered exchanges have discretion as to whether those rules will be enforced would leave the exchanges in the societally unacceptable status of private clubs which existed before the passage of the Act. *Silver v. New York Stock Exchange*, 373 U.S. 341, 351 (1962). While completely discretionary enforcement is an unacceptable interpretation of Section 6, so too is the inflexible position urged by appellant. Because the securities industry is a critical and sensitive part of our economic structure, the Exchange's regulatory approach should properly include an overview of the potential effects of its action. Flexibility in regulatory response is critical if the response is to be appropriate to the situation. The analysis of the United States Supreme Court in *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975),

demonstrates the importance of flexibility in the regulation of the securities industry. That cause required the Court's interpretation of the Securities Investment Protection Act of 1970, 15 U.S.C. §78aaa, *et seq.*, an act established to provide statutory protection for customers of failing broker-dealers such as Dempsey.[8] The precise question before the Court was whether an implied private right of action existed by which an individual might petition a district court to determine if the statutory conditions requiring liquidation

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[8]The Court described the SIPC procedure as follows:

"To this end, the SIPC is required to establish and maintain a fund for customer protection by laying assessments on the annual gross revenues of its members. The SEC and the securities industry self-regulatory organizations are required to notify the SIPC whenever it appears that a member is in or approaching financial difficulty. If the SIPC determines that a member has failed or is in danger of failing to meet its obligations to customers, and finds any one of five specified conditions suggestive of financial irresponsibility, then it 'may apply to any court of competent jurisdiction . . . for a decree adjudicating that customers of such member are in need of the protection provided by [the Act].' 15 U.S.C. §78eee(2).

"The mere filing of an SIPC application gives the court in which it is filed exclusive jurisdiction over the member and its property, wherever located, and requires the court to stay 'any pending bankruptcy, mortgage foreclosure, equity receivership, or other proceeding to reorganize, conserve, or liquidate the [member] or its property and any other suit against any receiver, conservator, or trustee of the [member] or its property.' 15 U.S.C. §78eee(b)(2). If the SEC has pending any action against the member, it may, with the Commission's consent, be combined with the SIPC proceeding. If no such action is pending, the SEC may intervene as a party to the SIPC proceeding.

"If the court finds any of the five conditions on which an SIPC application may be based, it must grant the application and issue the decree, and appoint as trustee for the liquidation of the business and as attorney for the trustee, 'such persons as SIPC shall specify.' 15 U.S.C. §78eee(b)(1), (3).

"The trustee is empowered and directed by the Act to return customer property, complete open transactions, enforce rights of subrogation, and liquidate the business of the member, 15 U.S.C. §78fff(a); he is not empowered to reorganize or rehabilitate the business. The SIPC is required to advance to him such sums as are necessary to complete open transactions, and to accomplish the return of customer property up to a value of $50,000. §78fff(f)." 421 U.S. at 416-417.

existed. The Court refused to imply such a private right of action. For our purposes the importance of the Court's analysis is in its emphasis on the policy considerations open to Securities Investor Protection Corporation (''SIPC'') in deciding whether to petition for liquidation:

> ''The SIPC properly treats an application for the appointment of a receiver and liquidation of a brokerage firm as a last resort. It maintains an early warning system and monitors the affairs of any firm that it is given reason to believe may be in danger of failure. Its experience to date demonstrates that more often than not an endangered firm will avoid collapse by infusion of new capital or merger with a stronger firm. [footnote omitted] Even failing those alternatives, a firm may be able to liquidate under the supervision of one of the self-regulatory organizations, or the District Court, without danger of loss to customers. The SIPC's policy, therefore, is to defer intervention 'until there appear[s] to be no reasonable doubt that customers would need the protection of the Act.' SIPC 1973 Annual Report 7 (1974). By this policy, the SIPC avoids unnecessarily engendering the costs of precipitious [sic] liquidations — the costs not only of administering the liquidation, but also of customer illiquidity and additional loss of confidence in the capital markets — without sacrifice of any customer protection that may ultimately prove necessary.'' 421 U.S. at 421-422.

The Court also pointed to the extreme consequences that actions such as liquidation or suspension, or even the threat of them, can have:

> ''Except with respect to the solidest of houses, the mere filing of an action predicated upon allegations of financial insecurity might often prove fatal. [footnote omitted] Other customers could not be expected to leave their cash and securities on deposit, nor other brokers to initiate new transactions that the firm might not be able to cover when due if a receiver is appointed, nor would suppliers be likely to continue dealing with such a firm. These consequences are too grave, and when unnecessary, too inimical to the purposes of the Act, for the Court to impute to Congress an intent to grant to every member of the investing public control over their occurrence. On the contrary, they seem to be the very sorts of considerations that motivated Congress to put the SIPC in the hands of a public board of directors, responsible to an agency experienced in regulation of the securities markets. [footnote omitted]'' *Id.* at 322-423.

The Securities Investors Protection Act does not apply to the facts of this case, but, in our view, the policy considerations mentioned by Justice Marshall are helpful in our analysis of the Exchange's actions in the instant case. At the time of this case, the difficult policy considerations faced the Exchange rather than the SIPC. We believe that the same flexibility in response should be allowed the Exchange as is now allowed the SIPC. As long as the Exchange takes prompt action to investigate alleged violations, and, having ascertained that violations exist, takes action reasonably designed to restore compliance with the rules, courts should not substitute their retrospective judgment concerning the appropriate action. The evaluation of an exchange's response to a violation of its rules must be made in the light of all the circumstances of the particular case. Because each case must be individually evaluated, no standard formula is possible. However, one important factor will frequently be present.

The regime established by the Securities Exchange Act is one of "supervised self-regulation" (*Colonial Realty Corporation v. Bache & Co.*, 358 F.2d 178, 182 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966)), suggesting that the supervisory role of the Commission is relevant to an alleged breach of an exchange's Section 6 duty.

The involvement of the Commission in a case is significant because it is the governmental authority charged with the enforcement of the provisions of the Securities Exchange Act. Private causes of action under the Act are justified in part because they serve to supplement the Commission's enforcement efforts. If the Commission expressly endorses a particular regulatory action taken by an exchange, that endorsement should properly be given considerable weight by a court hearing a claim that the same action constitutes a violation of the exchange's Section 6 duty. The obvious difficulty comes in attempting to determine the appropriate weight to be given to Commission action or inaction which falls short of express endorsement. For the most part, this determination must be made on a case-by-case basis, taking into account the amount of information available to the Commission, the extent of its involvement, and the fact that the Commission has been given a secondary rather than a primary enforcement role with regard to exchange rules.

The district court found that the Commission had not taken any "formal" action against the Exchange pursuant to its powers under Section 19, 15 U.S.C. §78s.[9] In analyzing this

[9]Section 19 provides in relevant part:

"(a) The Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors —

"(1) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to withdraw the registration of a national securities exchange if the Commission finds that such exchange has violated any provision of

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inaction, the district court found that the options available to the Commission were limited by (1) the Exchange's "essentially exclusive control" of the relevant information concerning the condition of member firms, and (2) the refusal of the

this chapter or of the rules and regulations thereunder or has failed to enforce, so far as is within its power, compliance therewith by a member or by an issuer of a security registered thereon.

* * * * *

"(3) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a national securities exchange any member of [sic] officer thereof whom the Commission finds has violated any provision of this chapter or the rules and regulations thereunder, or has effected any transaction for any other person who, he has reason to believe, is violating in respect of such transaction any provision of this chapter or the rules and regulations thereunder.

"(4) And if in its opinion the public interest so requires, summarily to suspend trading in any registered security on any national securities exchange for a period not exceeding ten days, or with the approval of the President, summarily to suspend all trading on any national securities exchange for a period not exceeding ninety days.

"(b) The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing, and other charges; (10)

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Exchange to make its Trust Fund available to creditors of Dempsey if a receivership were imposed on the firm by the Commission. *Hughes, supra,* at 94,541. The court then concluded that the inaction on the part of the Commission could not be characterized as "an indication of either tacit administrative approval, or unequivocal administrative sanctioning of the Exchange's efforts vis-a-vis the Dempsey problem." *Id.*[10]

As already indicated, we do find some indication of tacit approval from the lack of Commission action. The district court's description of the role of the Commission and indeed the emphatic opposition by some of its officials to the Exchange plan at the meeting of October 24, 1969, suggests that lack of information was not a major obstacle to action by the Commission. The existence of the Trust Fund is completely irrelevant to an appraisal of the Commission's action or inaction. The Commission's duties and its choice of responses were established by statute. There was no statutory recognition of or provision for the Trust Fund, which was the creation of the Exchange and its members.

The district court also held that the inaction by the Commission did not immunize the Exchange from liability under

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minimum units of trading; (11) odd-lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters."

[10]In a different part of the opinion, the district court distinguished its resolution of the instant case from the *Baird* court's determination that a breach of duty had occurred, in part because of the difference in the Commission's role in the two cases. It noted that in *Baird* the Commission's role was "virtually nonexistent" because of the surreptitious nature of Whitney's activities. In contrast, in the instant case, "the Exchange did make some *attempt* to inform the Commission and all subsequently interested persons, including King and Hughes, of the past status and current condition of Dempsey (irrespective of the attempt's final effect.)". *Hughes, supra,* at 94,545. The court's language leaves it somewhat unclear whether the significant factor was the effort made by the Exchange or the involvement of the Commission.

Section 6. In reaching this conclusion, the court analogized the instant case to the Supreme Court decisions in *Silver v. New York Stock Exchange,* 373 U.S. 341 (1962), and *Ricci v. Chicago Mercantile Exchange,* 409 U.S. 289 (1973), in which the Court attempted to reconcile the potential conflict between the antitrust laws and regulatory schemes such as that established by the Securities Exchange Act.

In our view, the district court misconceived the lesson to be drawn from those and subsequent cases and drew too direct an analogy between them and the instant case. In *Silver* and its progeny the Supreme Court was faced with the problem of reconciling two bodies of law with potentially inconsistent norms. Implied immunity is the proper analysis where it appears that Congress intended for certain matters to be decided within the regulatory system established by the securities laws rather than to be subjected to the full force of the antitrust laws. The problem in the instant case is fundamentally different because there is only one body of law at issue. The difficulty here arises because there are two entities, the Exchange and the Commission, both of which are charged with the enforcement of the *same* law. Consequently, the issue here is the weight to be attached to the actions taken by the superior authority in assessing the reasonableness of the actions of the inferior one. The Supreme Court's decisions regarding implied antitrust immunity do bear on this question, but not in the way suggested by the district court.

The Court held in *Gordon v. New York Stock Exchange,* 422 U.S. 659, 691 (1975), . . . that the fact that a particular matter falls within the provisions of §19(b), 15 U.S.C. §78s, giving the Commission authority to "alter or supplement the rules of such exchange" is an important consideration in determining the weight to be attached to Commission action

or inaction in an antitrust action. When the exchange action at issue involves one of the categories listed in Section 19(b), the options open to the Commission are greater, and its action or inaction should be accorded greater weight. Applying this approach to the instant case, we find that Section 19(b) explicitly gives the Commission the power to initiate rule changes involving "safeguards in respect of the financial responsibility of members", which is precisely the subject at issue here.

Hughes has alleged violations by Dempsey of a large number of Exchange rules[11] as a basis for his claim that the Exchange breached its duty to enforce its rules. All of the violations were simply different manifestations of the same basic problems facing Dempsey. Our conclusion as to whether the Exchange has breached its duty turns on an assessment of the Exchange's response to those problems within the context of those rules, not on whether a particular rule has been violated. Therefore, it is not necessary for us to decide whether the violation of each of the various rules relied on by Hughes would by itself give rise to a private cause of action. *See Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966). It may, however, be useful to illustrate how we would apply several representative rules under the flexible analysis adopted above. For these purposes, we will use Article XIII of the New York Stock Exchange Constitution and Rule 325, each of which will, in our view, support a private cause of action.

Article XIII of the Exchange's Constitution was heavily relied upon by Hughes in his argument under Section 6. In

[11]The various rules at issue in this case and a summary of their provisions are set out in the district court's opinion. *Hughes, supra*, at 94,527 n. 2.

essence, it requires suspension by the Exchange of any member firm in the following three situations: (1) failure to perform its contracts, (2) insolvency, and (3) a financial or operating condition such that it cannot be permitted to continue in business with safety to its creditors or the Exchange. By its terms, Article XIII leaves no choice concerning the Exchange's response when its conditions are satisfied. However, the determination of the existence of the conditions does necessarily leave room for interpretation. We would not lightly second-guess the Exchange's assessment of safety of a particular firm's condition, but there clearly may be a point at which the Exchange's assessment could no longer be accepted.

Hughes also placed heavy emphasis on Dempsey's admitted violation of Exchange Rule 325 which specifies the maximum ratio of debt to net capital for member firms.[12] Rule 325 does not specify the appropriate action to be taken in the event that a member firm is in violation. As suggested

[12]New York Stock Exchange Rule 325 provides in relevant part:

"(a) No member or member organization doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 2000 per centum of his or its Net Capital, which Net Capital shall be not less than $25,000 in the case of any other member or member organization subject to this rule, unless a specific temporary exception is made by the Exchange in the case of a particular member or member organization due to unusual circumstances.

"The initial Net Capital of a member corporation shall be at least 120% of the Net Capital required to be maintained by this rule.

"The Exchange may at any time or from time to time in the case of a particular member or member organization prescribe greater requirements than those prescribed herein.

"Each member or member organization shall promptly notify the Exchange if his or its Net Capital does not equal or exceed the minimum required by this rule."

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above, we reject Hughes' argument that suspension is the only permissible response when a firm is found to be in net capital violation. The net capital rule is undoubtedly one of the most important provisions designed to protect the investing public, but an inflexible approach to its enforcement is not justified.

Having described the appropriate standards, we now turn to an evaluation of the Exchange's actions in the two relevant periods. With regard to the failure of the Exchange to suspend Dempsey in the fall of 1969, we agree with the district court's conclusion that the Exchange's conduct did not constitute a breach of its Section 6 duty. It is undisputed that in the fall of 1969 Dempsey had serious problems, including a serious violation of the Exchange's net capital rule. Given the industry-wide experience with many of the types of problems facing Dempsey, the restrictions imposed by the Exchange were reasonably addressed to the origins of Dempsey's problems. The failure to suspend Dempsey did involve certain risks, but so did the prospect of suspending the firm. The Exchange's response was not the most drastic one available to it, but given the legitimate concern over the effect which an immediate suspension of Dempsey might have on the entire securities industry, it was not an unreasonable one.

This conclusion is buttressed by the action of the Commission during the fall of 1969. Although there is evidence that certain officials at the Commission disagreed with the Ex-

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The Commission has its own net capital rule establishing minimum capital requirements for brokers, but it provides an exemption which includes "any member in good standing and subject to the capital rules * * * of the New York Stock Exchange * * * whose rules, settled practices and applicable regulatory procedures are deemed by the Commission to impose requirements more comprehensive than the requirements of this rule." SEC Rule 15(c)(3)-1(b)(2); *see* 17 C.F.R. §240.15c3-1(b)(2) (1973).

change's strategy, the Commission did not take any of the alternative courses of action available to it under the Securities Exchange Act.

Turning to the second relevant period, we conclude that the Exchange's decision to lift the previously imposed restrictions from Dempsey cannot be similarly sustained. Evaluated under the standard described above, that decision constituted a breach of the Exchange's Section 6 duty. The district court's holding to the contrary was "clearly erroneous" within the meaning of Section 52(a) of the Federal Rules of Civil Procedure. The Exchange had earlier attributed Dempsey's operational and financial problems in large part to the firm's inability to process its volume of business. The restrictions were generally designed to reduce that volume to a point at which the firm could handle it. In lifting the restrictions, the Exchange invited an aggravation of the very problems which had prompted the restrictions in the first place. The Exchange has presented nothing to support an argument that the restrictions were no longer necessary. Put simply, the Exchange cannot have it both ways. Either the restrictions were not a sufficient response to Dempsey's problems in the fall of 1969, indicating a breach of duty at that time, or they were a sufficient response, indicating that their subsequent removal was a breach of duty in March of 1970. Without the restrictions, the only response by the Exchange to the very serious problems of Dempsey was the addition of new capital. This failure of the Exchange to take constructive action toward the underlying problems of Dempsey constitutes a clear breach of its duty. If the Exchange determined that the lower level restrictions had not succeeded, it was obligated to suspend the firm. Instead, its attempted resolution so ignored the Exchange's duty owed to

investors and potential investors in Dempsey that it far exceeds any permissible degree of discretion or flexibility in choosing a response. We are bothered by the fact that the action of the Commission paralleled that of the Exchange in that the Commission lifted its prohibition on underwritings by the firm at the same time that the Exchange lifted its restrictions. The breach in this case is so clear, however, that the weight to be accorded to the Commission's action does not alter our conclusion.

HUGHES' RIGHT TO RECOVER FOR THE EXCHANGE'S BREACH

We have concluded that the district court erred in holding that the Exchange did not breach its Section 6 duty when it lifted the previously imposed restrictions from Dempsey. That conclusion raises the subsequent question of Hughes' right to recover for that breach. Because of its resolution of the first question, the district court naturally did not reach the second. Various theories which might be invoked to deny Hughes' right to recover have been briefed and argued. Considering the thoroughness of the district court's findings of facts and the already protracted nature of this litigation, we feel that it is both possible and appropriate to decide those issues at this time.

We hold that Hughes is barred by the doctrine of waiver[13]

[13]We emphasize that our conclusion that Hughes has waived his right to recover is not influenced by his signing a so-called "knowledgeability letter" directed to the Exchange. The letter stated that Hughes had investigated the desirability of the subordination agreement, that he was familiar with the restrictions imposed on Dempsey, and that he agreed that the Exchange would not be liable to him with respect to his subordination loan. Regardless of the applicability of the letter to the breach found in this case, any waiver included in such a letter would be rendered void by Section 29 of the Securities Exchange Act, 15 U.S.C. §78cc. We find Hughes to have waived any right to recover not from what he signed, but from what he knew and from what he did.

from recovering for any losses that he might have suffered as a result of the Exchange's breach of its Section 6 duty. In *Royal Air Properties, Inc. v. Smith,* 312 F.2d 210 (9 Cir. 1962), we held that the doctrine of waiver can be invoked to bar recovery in an implied civil action brought under Rule 10b-5. In appropriate circumstances, the same defense can be invoked to bar recovery in an implied civil action brought under Section 6. In the second appellate consideration of *Royal Air Properties, Inc. v. Smith,* 333 F.2d 568 (9 Cir. 1964), we stated that:

> "[W]aiver of rights under the Securities Exchange Act of 1934 should be limited to those cases where it is intended, and that therefore the right in question must be found to be actually known before waiver becomes effective." 333 F.2d at 571.

It is our opinion that the findings of fact of the district court indicate quite clearly that Hughes did knowingly waive his right to recover for the Exchange's breach of duty.

In the circumstances of this case, Hughes is an extremely unsympathetic plaintiff. Before entering into the subordination agreement, he knew the risks which accompanied his decision. However, for purposes of evaluating a possible waiver defense, it is necessary to focus more specifically on Hughes' knowledge of the action which has been determined to constitute a breach of the Exchange's duty — the lifting of the restrictions. Hughes not only knew of that action before he entered into the agreement, he actually contributed to its occurrence. He had actual knowledge that the Exchange had imposed restrictions on Dempsey's operations and that those restrictions had been imposed for the protection of the investing public, of which he was a part. Not only did Hughes invest with the actual knowledge that the restrictions had

been lifted, he also knowingly conditioned his agreement on the lifting of the restrictions. Allowing Hughes to recover for a breach of duty which he encouraged would not further the purposes of the Act. As we stated in the first *Royal Air Properties* case,

> "The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act." 312 F.2d at 213-214.

Hughes has lost his innocence.

HUGHES' OTHER SECURITY LAW CLAIMS

Hughes also challenges the district court's dismissal of his other claims based on the securities laws. These challenges essentially go to the findings of fact by the district court rather than the correctness of the legal standards applied by it. The lynchpin to the analysis of Hughes' arguments concerning these questions is the district court's finding that complete disclosure was made to Hughes on the eve of his execution of the subordination agreement. Having reviewed the record, we cannot conclude that the findings of the district court concerning disclosure were clearly erroneous. Therefore, they form the basis of our examination of the remaining issues in this appeal.

We begin our discussion with the alleged liability of Whitney under Rule 10(b)-5[14] for alleged misrepresentations in

[14]Rule 10(b)-5, 17 C.F.R. 204.10b-5, provides that:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements

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the negotiations leading up to Hughes' execution of the subordination agreement. The district court characterized these representations as constituting "an over-simplified, self-serving hunch that everything would work out all right, and to Hughes' ultimate benefit." *Hughes, supra,* at 94,549. With very little discussion, the court assumed that these representations did constitute a violation of Rule 10(b)-5, but, citing *Royal Air Properties, Inc. v. Smith,* 333 F.2d 568 (9th Cir. 1964), held that Whitney was not liable because Hughes had waived his right to recover. We agree with the Court's result but would reach it by a different route.

The extent of Whitney's duty must be determined according to the flexible, duty-oriented approach to Rule 10(b)-5 established in our recent decision in *White v. Abrams,* 495 F.2d 724 (9th Cir. 1974). Under this approach, synthesis must be made of a number of factors present in this case, some supporting the imposition of a heavy duty and some a light one. Certainly, several of the factors which we enumerated in *White* as supporting a heavy duty are present here. The relationship between Whitney and Hughes was a close and long-standing one. Whitney had initiated the contact with Hughes regarding the possibility of his entering into a subordination agreement, and Whitney obviously would have derived substantial benefit from the subordination if, as anticipated, it had been instrumental in Dempsey's recovery. The reliance element is more ambiguous: Hughes certainly did rely on Whitney's judgment in making investment decisions, but this reliance was far from complete, as indicated by

made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Hughes' own extensive business background and ability. The major factor present in this case supporting the imposition of a relatively lighter duty was characterized in *White* as relative access to the relevant information. This factor takes a somewhat different shape in this case than in *White*, because the issue here is misrepresentation rather than failure to disclose. The district court's conclusion that complete disclosure was made to Hughes cannot end our inquiry in this case, because even in the context of complete disclosure, a misrepresentation may cause the person to whom it is addressed to discount the other information available to him. *See* Bromberg, *Securities Law*, 8.4(651)(2). Nevertheless, the fact that complete disclosure has been made, making the plaintiff's access to the relevant information complete, is a major consideration in the determination of the duty question and the ultimate question of whether recovery should be allowed.[15]

We conclude that although Whitney owed a heavy debt to Hughes because of the previously mentioned factors, he did not breach that duty and, therefore, is not liable. The district court's opinion is clear that Whitney acted in good faith in making the representations to Hughes. The question of whether Whitney was negligent in making those representations is less clear, but in our view not critical. The court did find that neither Whitney nor Walraven were trained as professionals in making the kind of predictions at issue here.

The statements made by Whitney cannot be considered in isolation. They were made in the context of the total presentation made to Hughes regarding the subordination agreement. The opinion and information provided by Peck, which did

[15]"If plaintiff has true information, he is less likely (than if he is ignorant) to sustain a cause of action for misrepresentation of that information." Bromberg, *Securities Law*, 8.4(651)(2).

not support Whitney's overly optimistic views, was not merely separate contrary information available to Hughes. Rather, that information was actually solicited by Whitney in his effort to assure that Hughes was adequately informed of the consequences of his decision. There is simply no indication that Whitney was trying to provide enough disclosure to satisfy the minimum requirements of Rule 10(b)-5, while at the same time attempting to negate the effect of that information through the use of his influence on Hughes. Another important consideration bearing on our decision is the relative specificity of the information from Whitney and Peck. The district court emphasized the generality of the comments by Whitney and the specificity of the comments and information supplied by Peck. Although we do not hold that statements of opinion such as those made by Whitney are not actionable under Rule 10(b)-5,[16] the generality of the comments is a relevant consideration. The fact that Hughes was a sophisticated businessman, although admittedly not an expert accountant, also influences our consideration of the significance of the types of information given to him. We simply are not dealing with a gullible, defenseless investor unable to protect himself from the machinations of a vastly superior opposite party. We conclude that despite the relatively heavy duty owed by Whitney to Hughes, his general expressions of opinion, which were believed by him and made in good faith with due precaution taken to ensure full disclosure, simply did not constitute a breach of the duty imposed on him by Rule 10(b)-5.

We now turn to the other main contention of Hughes, that the Exchange is primarily liable under Rule 10(b)-5 for the

[16]Some expressions of opinion clearly are actionable. *See e.g., Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974); *G & M, Inc. v. Newbern*, 488 F.2d 742 (9th Cir. 1973).

actions it took in the course of its regulation of Dempsey after learning of the firm's violations of the rules. The district court held that Rule 10(b)-5 did apply to those actions by the Exchange because its involvement touched "every relevant facet of this case". *Hughes, supra,* at 94,552. The district court analyzed the question of the Exchange's liability by reference to its previous determination that the Exchange had not breached its duty under Section 6. While adequate performance of the Section 6 duty may in some ways suggest the absence of a violation of Rule 10(b)-5, we think that a more direct form of analysis is preferable. This conclusion is mandated in this case because of our reversal of the district court on the question of the Exchange's decision to lift the restrictions from Dempsey. We need not, however, pursue the analogy suggested by Hughes between the instant case and *Affiliated Ute Citizens v. United States,* 406 U.S. 128 (1972), because of the district court's finding that complete disclosure had been made to Hughes. That degree of disclosure is simply inconsistent with Hughes' argument that the Exchange's regulation of Dempsey was a "course of business" or a "device, scheme, or artifice" that operated as a fraud on Hughes.[17]

The failure of Hughes to establish the primary liability of the Exchange and of Whitney under the relatively most liberal requirement of Rule 10(b)-5 makes it unnecessary to discuss the other points raised by him on appeal concerning

[17]Hughes has attempted to argue for the first time on appeal that the Exchange is liable under Section 12(2) and 17(a) of the 1933 Act and Section 10(b) of the 1934 Act and Rule 10(b)-5 because of its participation in the preparation of the various materials supplied to Hughes by Peck. Although the district court did not directly address this question in its opinion, its treatment of the materials supplied by Peck is, in our view, inconsistent with a finding of liability. The district court, as noted above, found that Peck's presentation, oral and documentary, constituted full disclosure to Hughes.

possible liability under the less sweeping coverage of Sections 12(2) and 17(a) of the 1933 Act. We similarly reject Hughes' arguments concerning the vicarious liability of Dempsey for its employees or the vicarious liability of the Exchange as a "controlling person" of Dempsey. In our view, this is simply an inappropriate case for the "fraud" provisions of the securities laws, even with their expansive interpretation.

Affirmed.

SNEED, Circuit Judge (Concurring in result):

I reach the same conclusion as Judge Renfrew but by a somewhat different route.

The district court in my view was correct in holding that the Exchange did not violate its duty to Hughes in lifting in March, 1970 the restrictions which it had imposed in 1969.[1]

[1]The substance of the district court's position is as follows:

"The following are the dispositive conclusions of fact and law which provide the resolution to that question concerning the section 6 duty of the Exchange:

(1) the Exchange initially became aware of Dempsey's difficulties in 1964-1965, and, during that period, it *ordered compliance* by Dempsey with the Exchange's capital and record-keeping rules;

(2) the Exchange *subsequently restricted* Dempsey's business, including the limiting of weekly trades, and the requiring of an infusion of new capital, which eventually came from the Dempsey partnership;

(3) the Exchange *sanctioned Dempsey's management,* which eventually resulted in the installation of new leadership under Whitney;

(4) the Exchange sought to accommodate the interests and concerns of the Commission, the regulatory body ultimately responsible for the conduct of Dempsey, and attempted to cooperate as much as possible with that agency by keeping it apprised of developments (however, too often this effort was compromised and curbed by factors beyond the control of both the Exchange and the Commission, including imponderable economic forces);

(5) the Exchange solicited subordinated capital to shore up Dempsey, *but only under certain conditions* which were carefully and clearly communicated to the two proposed subordinators, King and Hughes, and which included a substantial *unknown factor* of

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Under the circumstances which the Exchange confronted in March, 1970 the lifting of the restrictions was within what Judge Renfrew describes as a "permissible degree of discretion or flexibility in choosing a response." See p. 26, *supra*. Lifting the restrictions is not made inappropriate merely because imposing them in 1969 was proper. The possibility of acquiring the subordinated capital of King and Hughes in 1970 placed before the Exchange new circumstances. The reasonableness of the Exchange's response thereto in the

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incalculable weight in affecting the eventual outcome of the subordination solution;

(6) the Exchange subsequently determined that Dempsey was facing increasingly serious difficulty, but that the planned subordinations still *might* solve Dempsey's problems, hence the Exchange determined not to suspend Dempsey, or to so restrict its business as to amount to a termination of Exchange support and backing — *such determination was highly presumptuous yet still implemented* in good faith;

(7) the Exchange viewed the proposed subordination by Hughes as a *partial remedy* for Dempsey, which view was essentially in accord with that of Peck (who had been hired by Dempsey under the reorganization efforts instigated by the Exchange, and who had also communicated in reasonably complete and coherent terms to Hughes at the final conference prior to subordination, and which was supported by documentation available for Hughes' personal, professional assessment for a sufficient period of time prior to his entry into subordination;

(8) the Exchange concluded that the *nature and extent of* the risk in the Hughes' subordination scheme was *reasonably apparent* to Hughes, and assumed that he was fully aware that Dempsey's recovery was premised on *contingent factors*, other than the mere infusion of a stated amount of capital, which factors were beyond the prediction and control of the Exchange, and thus beyond its duty to disclose;

(9) the Exchange's conclusions and assumptions, including its *doubt* about Dempsey's recovery, were patently described to Hughes by Peck, which description raised not only the hard "known" data at the time, but the presence of the "unknowns" which had to be accounted for; and

(10) the Exchange did not foresee, could not have foreseen, *nor should it have been required to foresee*, the subsequent surprise factor that market conditions would undergo a dramatic, rapid and sharp decline almost immediately after the Hughes' subordination entered into force — these market conditions were decisively fatal to

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light of changed conditions. The Exchange, in defending both the imposition and removal of restrictions, is not, in my opinion, having it both ways as Judge Renfrew suggests. It is defending a response made possible by the appearance of King and Hughes which was not unreasonable.

The possibility that this conclusion is erroneous does not trouble me greatly because I join Judge Renfrew in holding that Hughes is barred from recovery by waiver. I also agree that there should be no recovery under rule 10b-5 or the other provisions of the securities laws. The district judge found that Hughes had "*actual knowledge of all the material facts*

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the reorganization plan Peck explained to Hughes on the eve of subordination.

Based upon an overall assessment of the above dispositive conclusions, it cannot be determined that, under the specific circumstances of Hughes' subordination of his securities, the Exchange breached its section 6 duty toward Hughes, in light of the facts of which it had knowledge, or reasonably could have acquired, by the time of his subordination, and in light of the prior and contemporaneous conduct practiced and measures taken during the relevant period from the time the Exchange first became aware of Dempsey's deficiencies to the time of Hughes' subordination. Although it was controversial, it was not unreasonable for the Exchange to refrain from taking further, perhaps more drastic, measures against Dempsey prior to Hughes' subordination (particularly in light of the two priorities previously determined and implemented within its discretionary powers vis-a-vis member firms, which determination, incidentally, also stemmed from the section 6 obligation, *see* discussion, *supra* at 35. And, although it was momentous, it was not an abuse of discretion, nor a violation of a statutory charge, for the Exchange to affirmatively solicit a subordination with the character, qualifications, and understanding, of that which was eventually consummated with Hughes. A contrary finding under the section 6 theory of recovery would appear to place national securities exchanges in an impossible position of making an ultimate choice between two alternative courses of action — either to submit themselves to a form of strict liability for the potential risks inherent in the type of protective scheme devised to preserve Dempsey, or to forego equally important obligations — legal *and* ethical — to other members of their national organizations and their clients. Such a choice does not seem to make sense under the Securities Exchange Act for it would at once remove fundamental flexibilities and discretions necessary for the effective functioning of national securities exchanges. Accordingly, the section 6 duty accorded to Hughes under the Securities Exchange Act was not breached by the Exchange." (footnote omitted) [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶94,133 at p. 95,545 (Emphasis the court's).

available to a reasonably prudent investor . . . ." [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,133 at p. 94,549 (Emphasis the court's). This finding is not clearly erroneous. FED. R. CIV. P. 52(a). The quantum of disclosure provided Hughes, and his lack of diligence in analyzing those disclosures and reasonable inferences to be drawn therefrom, simply preclude Hughes from stating a 10b-5 cause of action against any of the defendants.[2]

TRASK, Circuit Judge (Concurring in the opinion in part but dissenting from the judgment):

I concur with the opinion of the majority in deciding that the acts and failures to act of the Exchange were violations of its section 6(b) responsibilities under the Securities Exchange Act of 1934, 15 U.S.C. § 78f(4) (b), which would entitle a plaintiff if injured by them to a private action for damages.[1] It

[2]There are a multitude of grounds available to articulate this denial of recovery to a plaintiff who has full knowledge, including no breach of duty of disclosure by the defendant, no due diligence by the plaintiff, no reliance by the plaintiff, waiver, and assumption of the risk. *See generally*, A. BROMBERG, SECURITIES LAW: FRAUD, Sec. 8.4(651)-(652) (1974).

[1]The Securities Exchange Act of 1934, 15 U.S.C. §78f(4) (b), indicates a clear intention to protect persons dealing through member brokers by providing for their suspension and expulsion. Such intent is cemented by section 6(d) which provides:

> "(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange."

Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa follows with a jurisdictional statement that

> "The district courts of the United States . . . shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder . . . "

Although *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), was an action by a stockholder against the corporation based upon section 14(a) of the Act,

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is clear also to me that those derelictions of the Exchange were a proximate cause of the loss sustained by Hughes.[2] I am unable to join with the majority's holding that Hughes is barred by the doctrine of waiver from recovering for the losses incurred as a result of a breach by the Exchange of its section 6 duty. I find this portion of the majority's opinion analytically unsound and predicated upon a series of assumptions which do not fit the facts of this case. Even were the facts otherwise, however, I would entertain serious doubts concerning the appropriateness of the waiver doctrine in a section 6(b) action against an exchange.

The majority's view is that by bargaining for the lifting of restrictions which he knew had been imposed for the protection of the investing public as a condition precedent to his subordination agreement, Hughes wavied his right to recover for the Exchange's breach of duty.[3] The standard of waiver the majority uses comes from *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568 (9th Cir. 1964), where we stated at 571, quoting in part *Matsuo Yoshida v. Liberty Mutual Insurance Co.*, 240 F.2d 824, 829 (9th Cir. 1957):

> "[W]aiver is 'the voluntary or intentional relinquishment of a known right. It emphasizes the mental attitude

the rationale of the Court would appear to sanction the use of section 27 to enable the courts "to grant all necessary remedial relief." 377 U.S. at 435. *See also Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 373 (1944); *Rich v. New York Stock Exchange*, 379 F. Supp. 1122 (S.D.N.Y. 1974); *Kroese v. New York Stock Exchange*, 227 F. Supp. 519 (S.D.N.Y. 1964).

[2]Although the majority does not discuss causation directly it is implicit from its denial of recovery on the basis of an affirmative defense. Lest there be any doubt, I would find that Hughes' loss is directly attributable to the failure of the Exchange to perform its statutory duty of regulation.

[3]I concur in and wish to re-emphasize what the majority points out at footnote 13, that a theory of waiver cannot be built around the "knowledgeability letter" which Hughes signed. I am in complete agreement with the majority that this disclaimer or waiver runs afoul of section 29(a) of the Act, 15 U.S.C. §78cc(a).

of the actor.' Since waiver is a voluntary act, there must be knowledge of the right in question before the act of relinquishment can occur."

We then went on to say:

"[W]aiver of rights under the Securities Exchange Act of 1934 should be limited to those cases where it is intended, and that therefore the right in question must be found to be actually known before waiver becomes effective."

I would add to this legal framework the common law principal that waivers in derogation of a statutory right are not favored and will not be inferred from doubtful acts or language. *Holden & Martin Lumber Co. v. Stuart,* 118 Vt. 286, 108 A.2d 387, 389 (1954), *Worley v. Johnson,* 60 Fla. 294, 53 S. 543, 545 (1910), *Colgate v. United States Leather Co.,* 73 N.J. Eq. 72, 67 A. 657, 663 (1907). Indeed, at common law, when the right in question was conferred for the benefit of the public at large rather than for the private benefit of individuals, courts employed a near-absolute prohibition upon the defense of waiver. *See City of Glendale v. Coquat,* 46 Ariz. 478, 52 P.2d 1178, 1180 (1935) and cases cited therein.

The majority relies upon the following passage from *Royal Air Properties:*

"The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act."

While Hughes may not have been a "babe in the woods," it does not follow, as the majority assumes, that his understanding of the implications of the decision to lift the restrictions approached that of the Exchange. Indeed, the evidence indicates that his understanding of this transaction was limited both by his own lack of experience in this sophisticated area of finance and by what the Exchange did and did not tell him.

Hughes was never made fully aware of the critical situation in which Dempsey-Tegeler found itself on and before March 24, 1970, when he placed his securities with Dempsey-Tegeler in subordination to the claims of its creditors. For example, the problems of Dempsey-Tegeler reached back as far as 1964 and 1965 when it was determined by the Exchange that as a result of its decentralized accounting system, the firm was in violation of the Exchange's capital and record-keeping rules. From that date until its demise, Dempsey-Tegeler never seemed to be able to completely comply with the requirements of a solvent passably-operated house.[4]

Mr. Tegeler was fined $10,000 on that occasion and two other voting stockholders were fined $10,000 and $2,000 each. A surprise audit in 1968 by Haskins & Sells, certified public accountants, again revealed serious capital and accounting problems in violation of Exchange rules and some sanctions were again imposed by the Stock Exchange. The audit of 1969 disclosed only a worsening situation. The Exchange conducted an analysis by its own examiners. Senior Exchange officers and Securities Exchange Act Commissioners had been meeting at intervals during the period.

Thus, as detailed by the district court, we come to the crucial period from August 1969 to March 24, 1970, when Hughes signed and sealed his fate. After the release of the

[4]Report of October 22, 1969, Exhibit 33.

audit report of 1969, the Commission and the Exchange became increasingly concerned with the Dempsey-Tegeler situation. Their disciplinary efforts had not been successful. A meeting was held on September 25, 1969, between representatives of the Commission, officers of the Exchange and officials of Dempsey-Tegeler. The gravity of the situation was reviewed but no action was taken except to keep a close watch on developments. During a second meeting between Exchange and Commission officials, strong disagreement occurred over the question of shutting Dempsey-Tegeler down and the appointment of a receiver. The Exchange opposed such action and it was not taken. On December 11, 1969, another meeting concerning the Dempsey-Tegeler problem was held. At this meeting, as the district court noted:

> ". . . the project to raise subordinated capital for Dempsey was mentioned in the context of the Exchange's suggestion that the Commission refrain from taking any action lest efforts to solve the capital deficiency problem be thwarted."

Hughes' meetings with Dempsey-Tegeler were proceeding during approximately the same period. As the majority points out, Walraven and Whitney, both Dempsey-Tegeler officials and confidants of Hughes, advised Hughes at the first meeting not to commit himself unless King subordinated his stock. The second meeting occurred in February 1970, at which time a subordination agreement similar to the one being proposed to King was also submitted to Hughes. As appears from the trial court's opinion, the hard facts were not laid out before Hughes. He was told that there were problems of record-keeping but that Dempsey-Tegeler was doing a big volume of business and that it was a "viable corporation."

As pointed out by the trial court[5] the restrictions were mentioned, but explained away by saying that the reduction of offices was to streamline operations and that Dempsey-Tegeler was "doing more business than they had capital to back up," and that this was the reason for needing the subordinated capital from Hughes and King. Hughes was thus given a small pill with a large sugar coating.

The third meeting between Hughes, Walraven and Whitney took place on March 23, 1970. Mr. Robert Peck, an accountant and vice-president of Dempsey-Tegeler, who had been employed to help solve the problems of the company, was also present. At this time there was plain talk by Peck, who told Hughes outright that there was a "good chance" that he might lose his money if he subordinated his securities. He presented Hughes with documents containing detailed financial data which he explained and which if understood and believed would constitute a clear warning of the great risk Hughes was taking. At the same meeting, Walraven and Whitney represented to Hughes that the proposed subordination was a good idea and that there was little risk of loss. As the trial court related, Walraven and Whitney told Hughes that "as long-standing friends and trust-worthy business advisors they would not suggest subordination to him if they seriously believed that he would suffer losses as a result." Their approach was to counteract the very negative presenta-

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[5] "Briefly, the January 29, 1970 memorandum . . . showed that the liquidation of Dempsey's securities positions and the delivery of Dempsey's customer accounts was 'proceeding slowly', that no progress had been made in the planned registration of Siboney stock and that Dempsey's efforts to reduce its fail diffierence account had 'succeeded only in increasing differences . . . .' . . . In addition, the memorandum noted that Dempsey was in 'a cash pinch' which was delaying the liquidation of securities positions . . . . This report corroborated the then opinion of the SEC staff that Dempsey was running out of cash . . . ." Appellant's Opening Brief at 22 n.16.

tion made by Peck. The district court concluded after listening to the evidence of what transpired at this meeting that Hughes "... simply followed the advice which he wanted to hear. And, he wanted to believe that subordination would be fruitful, and not based upon a substantial risk." Hughes took the documents with him and on the next day, March 24, 1970, signed the subordination agreement and collateral papers submitted for his signature, without change or modification.[6]

The district court described Hughes as a man:

> "... gifted with an uncommon ability to nurture and manage business enterprises; however, he was neither principally an investor of stocks, nor was he a trained and experienced accountant, knowledgeable in the finer details of data interpretation."

Even an experienced trader might not have understood the intricacies of the regulatory scheme of the Securities Exchange Act of 1934 and the Rules of the New York Stock Exchange. More to the point, it is highly unlikely that Hughes would have realized the significance of the violations of Rule 417, 325, 440 and 342 of the Exchange which Dempsey-Tegeler was charged. No evidence indicates that he did.

Hughes was not shown to have any knowledge of the history or details of the meetings between the Commission, the Exchange and Dempsey-Tegeler concerning the activities of Dempsey-Tegeler which created a violation of section 6(b), or of the extent of the violation by Dempsey-Tegeler of the rules of the Exchange, including the devastating report of

[6]King had executed a subordination agreement on March 19, 1970, a fact made known to Hughes. The papers included the hold-harmless letter which the Exchange required Hughes to sign.

October 22, 1969.[7] Nor was he shown to have any understanding of the laws and regulations by which the exchanges should be controlled and in turn regulate their own business. At the December 11, 1969, meeting between officials of the Commission, the Exchange and Dempsey-Tegeler, the Exchange suggested that no action be taken by the Commission lest the efforts of the Exchange to obtain subordinated capital be undermined. This was a bald recognition that the whole unvarnished truth would upset Mr. Hughes and the Dempsey-Tegeler rescue operation.

All of this may suffice to show that while Mr. Hughes was an outstanding businessman in his own field, in this particular transaction, pressured by friends desperate to have his financial support, he was far from the sophisticated investor the majority assumes. For all these reasons, Hughes was not in a position to understand the full implications of the decision to lift the sanctions. I therefore would attach little significance to his insistence that the sanctions be lifted as a prerequisite to executing the subordination agreement.

Moreover, in grasping onto this bit of bargaining by Hughes as a justification for applying the waiver doctrine, the

[7]This report to the Board of Governors of the Exchange from the Department of Member Firms, Dempsey-Tegeler & Co., Inc. and Jerome F. Tegeler incorporated an earlier report of a similar memorandum as of April 15, 1969, which found violations of Rules 417 and 419; 325; 440; 421.50; 342 and 402(a) and imposed a fine of not more than $100,000 on the firm, not more than $50,000 on Tegeler and not more than $5,000 on Albert Gurmmersbach, a Senior Vice President.

The October 1969 report found additional rules violations including Rule 325 (capital violation); 440 (failure to maintain accurate books and records); Rule 417 (failing to keep books and records sufficient to disclose its financial condition); Rule 402(a) (failing to segregate its customers fully paid securities); and Rule 342 (failing to maintain adequate supervision and control). It also charged failure to comply with the requirements of the report of April 15. Jerome F. Tegeler admitted the charges in writing and consented to a one-year suspension as an allied member of the New York Stock Exchange.

majority makes further unwarranted assumptions. Admittedly Hughes' motivation for insistence that the sanctions be lifted prior to the execution of the subordination agreement was self-interest. I don't think it follows, however, that when an investor bargains out of self-interest with an Exchange charged with a statutory duty of protecting the investing public, he forfeits his right to rely upon the Exchange's expertise and judgment. Bargaining for one's advantage is not tantamount in this instance to bargaining for an abandonment of a statutory duty.

The lifting of the restrictions was only the tip of the iceberg. They were imposed in the hope that Dempsey-Tegeler's underlying problem of impaired capital and questionable solvency would thereby be improved if not remedied. But neither the Exchange nor Dempsey-Tegeler nor the Commission was at all certain that the remedy would be effective. Hughes was encouraged to request that the restrictions on Dempsey-Tegeler be lifted, not by any basic understanding of the problem on his part, but at the strong suggestion of his friends at Dempsey-Tegeler who were eager to have their organization off and running again.

In arriving at the conclusion that he would execute the subordination agreement only if the Exchange would first agree to lift its sanctions, Hughes was entitled to assume, it seems to me, that investor welfare would be among the foremost considerations of the Exchange in making its decision. If he was not entitled to make this assumption, the self-regulation rationale of the 1934 act is gravely undermined.

This, then, leads me to the last of my difficulties with the application of the waiver doctrine here. The *Royal Properties* case makes clear that "waiver of rights under the Securities

Exchange Act of 1934 should be limited to those cases where it is intended." 33 F.2d at 571. The majority obviously assumes that the waiver defense was intended to apply in an action against an exchange brought under section 6 of the Act, although no court has ever so held. I have grave doubts as to whether this assumption is warranted.

The Securities and Exchange Act was enacted only after a Congressional determination that exchanges were incapable of curbing the abuses in the securities industry which had led to mishandling of investors' funds, wild speculation and general economic chaos after the Great Depression without some degree of government regulation. Dawidoff, *The Power of the Securities and Exchange Commission to Require Stock Exchanges to Discipline Members,* 41 Ford. L. Rev. 549, 551 (1973). Prior to this time, the exchanges were regarded as private clubs and were given great latitude by the court in disciplining errant members. As the Supreme Court noted in *Silver v. New York Stock Exchange,* 373 U.S. 341, 351 (1963):

> "As exchanges became a more and more important element in our Nation's economic and financial system, however, the private-club analogy became increasingly inapposite and the ungoverned self-regulation became more and more obviously inadequate, with acceleratingly grave consequences. This impotency ultimately led to the enactment of the 1934 Act.

It is thus clear that while Congress intended to retain the general principle of self-regulation in the 1934 Act, that principle was to be limited severely. In the colorful language of Mr. Justice Douglas, then Chairman of the SEC, "Government would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use but with the

hope it would never have to be used.'' Douglas, *Democracy and Finance* (Allen ed. 1940) 82, *quoted in Silver, supra,* at 352. The Congressional mandate is explicit, it seems to me, that the self-interest of the exchanges was not to be placed above their duty of effective self-regulation. To allow an exchange to sidestep liability by use of the waiver doctrine here thwarts the purpose of section 6 and takes us a step backward toward the private club environment which the 1934 Act sought to eradicate.

In this regard, I also note that there is a clear trend in the law today to limit severely, if not abolish altogether, traditional common law defenses in securities and antitrust actions, where considerations of public policy often outweigh whatever balance in equities the court finds between the individual litigants. *Perma-Life Mufflers v. International Parts Corp.*, 392 U.S. 134, 138 (1968). As *City of Glendale v. Coquat, supra,* indicates, this trend is not a dramatic departure from established common law principles.

In the securities area, cases frowning upon the use of common law defenses have involved actions against brokers rather than an exchange. *E.g., Pearlstein v. Scudder & German,* 429 F.2d 1136, 1141 (2d Cir. 1970), *Avery v. Merrill Lynch, Pierce, Fenner & Smith,* 328 F. Supp. 677, 680 (D.D.C. 1971), *Nathanson v. Weis, Viosin, Cannon, Inc.*, 325 F. Supp. 50, 55-57 (S.D.N.Y. 1971). The common rationale has been that Congress, in permitting brokers to enjoy a privileged and anti-competitive postion in the securities industry structure, has imposed upon them statutory responsibilities and charged them with an intimate knowledge of the industry which an individual investor is unlikely to achieve. If a limitation upon common law defenses available to a broker might in some instances allow an unscrupulous investor to recover, this consequence is balanced by the salutary effect which the threat of private suits can have in maintaining adherence to statutory commands. These suits are, in effect, an alternative to more direct government intervention — they help to keep the government's shotgun ''behind the door,'' to paraphrase Mr. Justice Douglas. Availability of common law defenses, such as *in pari delicto,* assumption of risk, equitable estoppel, and waiver serve to make this check upon abuses in the system's internal workings considerably less potent.

I find many of the same self-policing considerations at work when the action is directed toward an exchange rather than a broker. Even though the exchanges are only one step removed from the Securities Exchange Commission, and therefore more susceptible to direct government oversight, the unhappy facts of this case indicate that this proximity does not always assure smooth self-regulation. The information and expertise of the exchanges is also unlikely to be shared by the individual investor. Moreover, the responsibilities of the exchange emanate almost entirely from statute. Whereas a 10b-5 action against a seller of securities is in many senses analogous to a common law action for fraud, a cause of action against an exchange for a breach of statutory duty bears little resemblance to a common law action. For this reason, traditional common law defenses may be even less appropriate where the exchange is the defendant. Therefore, I think a public purpose might be served by eliminating the defense of waiver altogether from section 6 actions against an exchange.

Whether Congress intended to allow for a defense of waiver in an action against an exchange or whether the defense might otherwise be appropriate in section 6 actions

are close legal questions. The majority assumes without discussion that the answer to both questions is yes. I have my doubts.

I would be more disposed to go along with the majority and resolve these doubts in favor of this Exchange had it been candid with Hughes. It just was not. It had a duty to be so. It rather attempted to get by with a partial and very minimal disclosure and insisted upon Hughes signing a hold-harmless agreement to protect the Exchange against future liability. The hold-harmless letter submitted to Hughes to sign was obviously not a document drawn by the Exchange for the protection of the investor as would seem to be the appropriate role of the Exchange here. It was plainly and simply for the protection of the Exchange against action permitted by it which by implication it recognized might subject the investor to loss and it to litigation. This was not what Congress had in mind when it imposed upon the Securities and Exchange Commission a duty of regulation of exchanges and the Exchange imposed a duty of quality operation upon its members. It is the Exchange which must make the hard decisions. It has the facts and the expertise. If it chooses to risk half-way measures and encourage investments by half-informed investors, it should be held to shoulder the result if loss occurs.

I would therefore reverse and remand with directions to enter judgment against the New York Stock Exchange.

There remains the question of the disposition of the claims against Whitney and Dempsey-Tegeler.[8] It appears clear that upon these facts both Whitney and Dempsey-Tegeler are liable under the provisions of section 12(2) of the Securities Exchange Act of 1933, 15 U.S.C. § 77L and of section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. 240.10b-5, promulgated thereunder.

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[8]Hughes' claims against Walraven were dismissed during trial.

Rule 10b-5 provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(1) to employ any device, scheme, or artifice to defraud,
>
> "(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

The misrepresentations of Whitney and Walraven at the meeting with Peck were particularly insidious in defeating the analysis of the expert called in for the purpose of establishing a record of disclosure. Their participation throughout was an exercise in conflict of interest with representation on the one hand and misrepresentation on the other. For the same reasons, Dempsey-Tegeler, as the principal on whose behalf Whitney and Walraven were acting, is equally responsible. The basic misrepresentation throughout was that Dempsey-Tegeler was fundamentally sound financially and that with the participation of King the contribution of Hughes would make the future secure for Dempsey-Tegeler. Nothing could have been farther from the truth.

I would therefore also reverse and remand with directions to enter judgment against Dempsey-Tegeler & Co., Inc., and Lewis Whitney.